Cross Telephone Company, L.L.C.

Audit Appeal to FCC

Exhibit 1

USAC Appeal, Attachments C - G

Cross Telephone Company, L.L.C.

ATTACHMENT C

2009 Audit USAC Response

USAC
Universal Service Administrative Company

High Cost and Low Income Division

USAC Management Response

Date: August 4, 2010

Subject: Improper Payment Information Act (IPIA) Audit of the High Cost Program of CROSS TEL CO, HC-2009-FL-067, Follow-up Audit to HC-2007-220

USAC management has reviewed the IPIA Performance Audit of CROSS TEL CO ("the Carrier"), SAC 431985. The audit firm KPMG LLP has issued recommendations in its follow-up audit report. Our response to the audit is as follows:

Finding 1
Condition:
The Beneficiary did not utilize an appropriate cost causative methodology, supported by underlying documentation, to allocate or assign common costs between regulated and non-regulated activities in accordance with the Part 64 Cost Allocation Rules during 2004 and 2005. In addition, the Beneficiary miscalculated a Related Party Transaction billing amount. [please see audit report]

Management Response:
USAC High Cost management concurs with the auditor. Failure to submit accurate financial data may result in incorrect payments from the USF. It is the obligation of a carrier to ensure that it is providing accurate data consistent with FCC rules.

USAC management directs the Carrier to implement internal controls necessary to review and reconcile source documentation and reported USF data prior to their submittal, and requests that the Carrier provide a detailed update of specific corrective actions no later than 60 days after receipt of this management response. (Please send to USAC High Cost at hcaudits@usac.org when submitting this information.)

Finding 2
Condition:
KPMG reviewed the Beneficiary's calculations used to determine tax amounts reported on the 2004 and 2005 USF Forms and noted the following: [please see audit report]

Management Response:
USAC High Cost management concurs with the auditor. Failure to submit accurate financial data may result in incorrect payments from the USF. It is the obligation of a carrier to ensure that it is providing accurate data consistent with FCC rules.

USAC management directs the Carrier to implement internal controls necessary to review and reconcile source documentation and reported USF data prior to their submittal, and requests that the Carrier provide a detailed update of specific corrective actions no later than 60 days after receipt of this management response. (Please send to USAC High Cost at hcaudits@usac.org when submitting this information.)

As directed by the FCC, USAC is obligated to implement all recommendations arising from the audits including recovery of funds that may have been improperly disbursed to beneficiaries. Therefore, USAC will recover High Cost support in the amount of $393,053.

Finding 3
Condition:
The Beneficiary did not retain documentation supporting the allocation of executive compensation costs charged by the parent company to the Beneficiary and its affiliates and the allocation of

these costs among the Beneficiary's accounts in 2004 and 2005. KPMG recalculated the allocation of executive compensation costs using a general allocator of operating expenses, less executive compensation, at an affiliate an account level and noted that in 2004 and 2005, the Beneficiary's share of executive compensation costs should have been $1,018,107 and $1,192,183, which is $781,293 and $607,817 lower, respectively, than the Beneficiary's actual allocation. These differences are classified by expense account as follows: [please see audit report]

Management Response:
USAC High Cost management concurs with the auditor. The Carrier does not have documentation consistent with Part 32 rules necessary to support account data reported in its filings with the National Exchange Carrier Association (NECA) and USAC.

USAC recognizes the Carrier has addressed its internal controls related to this finding.

As directed by the FCC, USAC is obligated to implement all recommendations arising from the audits including recovery of funds that may have been improperly disbursed to beneficiaries. Therefore, USAC will recover High Cost support in the amount of $220,308.

Finding 4
Condition:
KPMG reviewed the reasonableness of MBO Aviation expenses totaling $315,354 in 2004 and $300,266 in 2005. For 2004 and 2005, 11 out of 26 flights totaling $127,363, and 9 out of 21 flights totaling $133,431, respectively, were incorrectly recorded to Executive Expense (Account 6711) and should have been recorded to a non-regulated account or allocated to another affiliate. Results are based on a flight summary prepared by the Beneficiary which describes the business purpose, attendees, and amounts related to all flights purchased during 2004 and 2005. KPMG detail tested two sample invoices which detail costs associated with two out of the 47 trips taken in 2004 and 2005 and discussed and reviewed additional analysis performed by the Beneficiary.

Management Response:
USAC High Cost management concurs with the auditor. Failure to submit accurate financial data may result in incorrect payments from the USF. It is the obligation of a carrier to ensure that it is providing accurate data consistent with FCC rules.

USAC recognizes the Carrier has addressed its internal controls related to this finding.

As directed by the FCC, USAC is obligated to implement all recommendations arising from the audits including recovery of funds that may have been improperly disbursed to beneficiaries. Therefore, USAC will recover High Cost support in the amount of $27,107.

Finding 5
Condition:
Labor hours for two out of ten employees selected for payroll testing were inappropriately classified in 2004 and 2005 as follows:

- A Marketing Manager recorded 1,152 hours and 1,763 hours, in 2004 and 2005 respectively, representing $30,605 and $56,187, respectively, in payroll expense, to Digital Electronic Switching Expense (Account 6212) and should have recorded these hours to Marketing Expense (Account 6610).
- A Broadband Technician recorded 1,941 hours and 1,645 hours, in 2004 and 2005 respectively, representing $49,309 and $39,704, respectively, in payroll expense, to Digital Electronic Switching Expense (Account 6212) and should have recorded these hours to a non-regulated account.

Management Response:
USAC High Cost management concurs with the auditor. Failure to submit accurate financial data may result in incorrect payments from the USF. It is the obligation of a carrier to ensure that it is providing accurate data consistent with FCC rules.

USAC recognizes the Carrier has addressed its internal controls related to this finding.

As directed by the FCC, USAC is obligated to implement all recommendations arising from the audits including recovery of funds that may have been improperly disbursed to beneficiaries. Therefore, USAC will recover High Cost support in the amount of $20,622.

Audit Recovery Total

	HCL	LSS	ICLS	Finding Total
Finding 1	($287,308)	(139,735)	(279,307)	(706,350)
Finding 2	369,649	(2,473)	25,877	393,053
Finding 3	54,720	17,508	148,080	220,308
Finding 4	-	5,547	21,560	27,107
Finding 5	13,460	10,169	(3,007)	20,622
Mechanism Total	$150,521	(108,984)	(86,797)	**$0**

As a matter of administrative practice, USAC does not disburse funds due to audit where the net variances in USF support calculations would otherwise entitle a carrier to recovery of funds.

This concludes the USAC management response to the audit.

CONFIDENTIAL AND PROPRIETARY
Confidential Treatment Requested Pursuant to 47 C.F.R. 54.711(b)

Cross Telephone Company, L.L.C.

ATTACHMENT D

Draft Cross Summary of Findings

DRAFT Cross Summary of Findings as of 6/30/2010

1. HC-2009-FL067-F01: <u>Unsupported Common Cost Allocations and Assignment between Regulated and Non-regulated Activities and Miscalculated Related Party Transactions</u>

Condition

The Beneficiary did not utilize an appropriate cost causative methodology, supported by underlying documentation, to allocate or assign common costs between regulated and non-regulated activities in accordance with the Part 64 Cost Allocation Rules during 2004 and 2005. In addition, the Beneficiary miscalculated a Related Party Transaction billing amount.

- Cost allocations were not completely and accurately performed for the following items in 2004 and 2005:
  - In 2004, assets recorded in General Purpose Computers (Account 2124), totaling $58,934, were used for non-regulated activities and not removed from the regulated account balance.
  - In 2004 and 2005, six vehicles recorded in Motor Vehicles (Account 2112), totaling $131,706 and $169,567, were used for non-regulated activities and not removed from the regulated account balance.
  - In 2004 and 2005, assets recorded in Office Equipment (Account 2123), totaling $12,895 and $14,137, were used for non-regulated activities and not removed from the regulated account balance.
  - In 2004 and 2005, expenses recorded in General Support Facility Expense (Account 6120), totaling $6,449 and $13,286, related to non-regulated activities and were not removed from the regulated account balance.
  - In 2004 and 2005, Accumulated Depreciation - TPIS (Account 3100), totaling $87,304 and $174,934, related to non-regulated assets was not removed from the regulated account balance.
  - In 2004 and 2005, Depreciation Expense (Account 6560), totaling $5,319 and $22,569, related to non-regulated assets was not removed from the regulated account balance.
  - In 2004 and 2005, Executive and Planning Expense (Account 6710), totaling $100,204 and $109,802, related to non-regulated activities was not removed from the regulated account balance.
  - In 2004 and 2005, General and Administrative Expense (Account 6720), totaling $45,616 and $49,658, related to non-regulated activities was not removed from the regulated account balance.
  - In 2004 and 2005, C&WF Deferred Tax Liability (Account 4340-2410), totaling $15,473 and $12,806, related to non-regulated assets was not removed from the regulated account balance.
  - In 2004 and 2005, Operating Tax Expense (Account 7200), totaling $90,729 and $62,029, related to non-regulated activities was not removed from the regulated account balance.

- Non-regulated assets and expenses were improperly recorded in regulated accounts in 2004 and 2005:
  - In 2004, set top boxes, audio cables and modems, totaling $10,132, were included in Materials and Supplies (Account 1220).
  - In 2004, lease expenses related to Internet services and port charge, totaling $4,706, were included in Central Office Transmission Expense (Account 6232).
  - In 2004 and 2005, C&WF materials related to cable television, totaling $419, were included in Buried Cable (Account 2423).
  - In 2004 and 2005, IP Resource Cards, totaling $38,757, were included in Central Office Transmission (Account 2230).
  - In 2004 and 2005, Gigabit Ethernet Cards, totaling 37,042, were included in Central Office Transmission (Account 2230).
  - In 2004 and 2005, consulting expenses related to video and wireless services, totaling $5,367 and $630, were included in General and Administrative Expense (Account 6720).
  - In 2005, meals and entertainment expenses related to a regulated and non-regulated management meeting, totaling $642, were included in Executive Expense (Account 6710).
- In 2004 and 2005, expenses paid to an affiliate for leased DS1 circuits were miscalculated. Payments were calculated based on 52 and 7 DS1 circuits leased between Warner and UCAT and Warner and ATT Muskogee when the actual number of DS1 circuits leased were 161 and 7, respectively, in 2004, and 169 and 6, respectively, in 2005. This miscalculation resulted in Central Office Transmission Expense (Account 6232) being lower by $1,438,800 in 2004 and $1,537,800 in 2005 calculated in the table below:

2004 and 2005 Leased DS1 Adjustments

Route	Year	Circuit Count	Periods Covered	Circuit Cost	Total
Original Warner to UCAT Cost	2004	52	12	$1,100	$686,400
Revised Warner to UCAT Cost	2004	161	12	$1,100	$2,125,200
Total 2004 Variance					**($1,438,800)**
Original Warner to UCAT Cost	2005	52	12	$1,100	$686,400
Revised Warner to UCAT Cost	2005	169	12	$1,100	$2,230,800
2005 Warner to UCAT Variance					**($1,544,400)**

Original Warner to ATT Muskogee Cost	2005	7	12	$550	$46,200
Revised Warner to UCAT Cost	2005	6	12	$550	$39,600
2005 Warner to ATT Muskogee Variance					**$6,600**
Total 2005 Variance					**($1,537,800)**

- In 2004, amounts paid to an affiliate for the purchase of communications equipment recorded in Office Equipment (Account 2123) for $70,237 were $16,209 greater than the net book cost of $54,028 supported by the original vendor invoice.

Criteria

According to 47 C.F.R. § 32.14(c), "When a regulated activity involves the common or joint use of assets and resources in the provision of regulated and nonregulated products and services, companies shall account for these activities within the accounts prescribed in this system for telephone company operations. Assets and expenses shall be subdivided in subsidiary records among amounts solely assignable to nonregulated activities, amounts solely assignable to regulated activities, and amounts related to assets used and expenses incurred jointly or in common, which will be allocated between regulated and nonregulated activities."

In addition, according to 47 C.F.R. § 32.6232(a), "This account shall include expenses associated with circuit equipment."

In addition, according to 47 C.F.R. § 54.202(e), "All eligible telecommunications carriers shall retain all records required to demonstrate to auditors that the support received was consistent with the universal service high-cost program rules. These records should include the following: data supporting line count filings; historical customer records; fixed asset property accounting records; general ledgers; invoice copies for the purchase and maintenance of equipment; maintenance contracts for the upgrade or equipment; and any other relevant documentation. This documentation must be maintained for at least five years from the receipt of funding."

In addition, according to 47 C.F.R. § 64.901(b)(iii), "Costs which cannot be directly assigned to either regulated or nonregulated activities will be described as common costs. Common costs shall be grouped into homogeneous cost categories designed to facilitate the proper allocation of costs between a carrier's regulated and nonregulated activities. Each cost category shall be allocated between regulated and nonregulated activities in accordance with the following hierarchy: (iii) When neither direct nor indirect measures of cost allocation can be found, the cost category shall be allocated based upon a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and nonregulated activities."

Cause

The Beneficiary does not have effective policies and procedures to ensure the complete and accurate categorization of accounts, the accurate calculation of account balances, and the complete and accurate allocation of common costs between regulated and non-regulated activities.

Effect

The exceptions identified above have an impact on HCL, LSS and ICLS disbursements. The monetary impact of this finding relative to disbursements made from the USF for the HCP for the twelve-month period ended June 30, 2007 is estimated as follows:

- HCL disbursements calculated in the 2004 and 2005 data submissions were approximately $287,308 lower than they would have been had amounts been reported properly[1].
- LSS disbursements calculated in the 2005 data submission were approximately $139,735 lower than they would have been had amounts been reported properly.
- ICLS disbursements calculated in the 2004 data submission were approximately $279,307 lower than they would have been had amounts been reported properly.

Recommendation

The Beneficiary should enhance policies and procedures governing the complete and accurate account categorization, the accurate calculation of account balances, the complete and accurate common cost allocations between regulated and non-regulated activities, and its retention of supporting documentation in accordance with the Part 32 and Part 64 Rules and Regulations.

Beneficiary Response

The Beneficiary disagrees with the finding that it misallocated assets and expenses relating to Gigabit Ethernet cards to regulated accounts in 2004 and 2005. These assets are critical network elements that are required to provide regulated wholesale services.

The Beneficiary agrees that expenses paid to an affiliate for leased DS1 circuits were miscalculated. The number of DS1 circuits was not updated for the years in question, and thus, the billings did not include the additional circuits. The company is reviewing its procedures for updating this type of information to ensure that such errors do not occur in the future. The error was the result of an oversight and was not the result of an intentional or systematic failure to comply.

[1] Monetary impacts resulting from adjustments to Executive Expense (Account 6710) and General and Administrative Expense (Account 6720), and the related impacts on Operating Income Tax Expense (Account 7200), were reported as zero for 2004 and 2005 HCL disbursements. Exceptions noted for 2004 and 2005 reduced Executive Expense (Account 6710) and General and Administrative Expense (Account 6720) amounts reported on the HCL Forms to amounts that remained above the cap level which resulted in zero impact to HCL disbursements.

The Beneficiary notes that the net monetary effect of these findings is an under-recovery of support.

2. HC-2009-FL067-F02: Inaccurate Tax Calculations

Condition

KPMG reviewed the Beneficiary's calculations used to determine tax amounts reported on the 2004 and 2005 USF Forms and noted the following:

- In 2004 and 2005, the tax expense calculations were performed using prior period financial statement tax rate, rather than current year financial statement tax rate. Additionally, in 2004 and 2005, the tax expense calculations were performed using consolidated, rather than the tax rates applicable to CTC.

- In 2004 and 2005, the tax expense calculations did not take into consideration the following items: the federal benefit of state income tax expense, and the effect of non-regulated asset adjustments for both property taxes and deferred tax liabilities.

KPMG recalculated the tax amounts by considering the above items and noted the following:

- In 2004, the recalculated total Operating Income Tax Expense (Account 7200) of $2,617,623, was less than the amount on the 2005-1 HCL form of $3,448,081 with a difference of $830,458.

- In 2004, the recalculated Deferred Tax Liability (Account 4340) of $4,799,492, was less than the amount on the Part 64 Allocation Study of $5,380,800 with a difference of $581,308.

- In 2005, the recalculated total Operating Income Tax Expense (Account 7200) of $2,106,516, was less than the amount on the 2006-1 HCL form of $2,871,964 with a difference of $765,448.

- In 2005, the recalculated Deferred Tax Liability (Account 4340) of $4,183,127, was less than the amount on the Part 64 Allocation Study of $4,883,362 with a difference of $700,235.

Criteria

According to 47 C.F.R. § 32.4340(b), "This account shall be credited or debited, as appropriate, and Account 7250, Provision for Deferred Operating Income Taxes--Net, shall reflect the offset for the tax effect of revenues and expenses from regulated operations which have been included in the determination of taxable income, but which will not be included in the determination of book income or for the tax effect of revenues and expenses from regulated operations which have been included in the determination of book income prior to the inclusion in the determination of taxable income."

In addition, according to 47 C.F.R. § 32.7250(a) and (b), "This account shall be charged or credited, as appropriate, with contra entries recorded to the following accounts for income tax expense that has been deferred in accordance with Sec. 32.22 of Subpart B. Subsidiary record categories shall be maintained to distinguish between property and nonproperty related deferrals and so that the company may separately report that amounts contained herein that relate to Federal, state and local income taxes. Such subsidiary record categories shall be reported as required by part 43 of this Commission's Rules and Regulations."

Cause

The Beneficiary does not have effective preparation, review and approval processes to ensure income tax accounting and reporting related to the amounts reported on the USF Forms is complete and accurate.

Effect

The exceptions identified above have an impact on HCL, LSS and ICLS disbursements. The monetary impact of this finding relative to disbursements made from the USF for the HCP for the twelve-month period ended June 30, 2007 is estimated as follows:

- HCL disbursements calculated in the 2004 and 2005 data submissions were approximately $369,649 higher than they would have been had amounts been reported properly.
- LSS disbursements calculated in the 2005 data submission were approximately $2,473 lower than they would have been had amounts been reported properly.
- ICLS disbursements calculated in the 2004 data submission were approximately $25,877 higher than they would have been had amounts been reported properly.

Recommendation

The Beneficiary should enhance the review of tax accounting policies and procedures to ensure that all appropriate accrual and allocation entries are recorded and reviewed in accordance with the Part 32 and Part 64 Rules and Regulations.

Beneficiary Response

The Beneficiary disagrees that the tax amounts reported on USF Forms were calculated improperly. The Beneficiary disagrees with KPMG's calculation of the regulated tax expense as it includes:

- Management fees of $581,435 in 2004 and $423,132 in 2005, which should each have been included in non-regulated accounts; and
- Non-operating fixed charges of $510,875 in 2004 and $492,755 in 2005.

Thus, the tax expense should have been significantly greater, which would have resulted in a lower monetary effect than KPMG calculated for this finding.

3. **HC-2009-FL067-F03: <u>Unsupported Executive Compensation Allocations</u>**

Condition

The Beneficiary did not retain documentation supporting the allocation of executive compensation costs charged by the parent company to the Beneficiary and its affiliates and the allocation of these costs among the Beneficiary's accounts in 2004 and 2005. KPMG recalculated the allocation of executive compensation costs using a general allocator of operating expenses, less executive compensation, at an affiliate an account level and noted that in 2004 and 2005, the Beneficiary's share of executive compensation costs should have been $1,018,107 and $1,192,183, which is $781,293 and $607,817 lower, respectively, than the Beneficiary's actual allocation. These differences are classified by expense account as follows:

- In 2004 and 2005, Network Operations Expense (Account 6530) should have been $90,765 and $105,939, which is $199,859 and $184,685 lower, respectively, than the Beneficiary's actual allocation.
- In 2004 and 2005, Executive Expense (Account 6711) should have been $431,280 and $522,121, which is $224,972 and $134,131 lower, respectively, than the Beneficiary's actual allocation.
- In 2004 and 2005, Accounting and Finance Expense (Account 6721) should have been $218,340 and $233,519, which is $306,660 and $291,481 lower, respectively, than the Beneficiary's actual allocation.
- In 2004 and 2005, Other General and Administrative Expense (Account 6728) should have been $277,722 and $330,604, which is $50,402 lower and $2,480 higher, respectively, than the Beneficiary's actual allocation.

Criteria

According to 47 C.F.R. § 32.12(b), "The company's financial records shall be kept with sufficient particularity to show fully the facts pertaining to all entries in these accounts. The detail records shall be filed in such manner as to be readily accessible for examination by representatives of this Commission."

In addition, according to 47 C.F.R. § 54.202(e), "All eligible telecommunications carriers shall retain all records required to demonstrate to auditors that the support received was consistent with the universal service high-cost program rules. These records should include the following: data supporting line count filings; historical customer records; fixed asset property accounting records; general ledgers; invoice copies for the purchase and maintenance of equipment; maintenance contracts for the upgrade or equipment; and any other relevant documentation. This documentation must be maintained for at least five years from the receipt of funding."

In addition, according to 47 C.F.R. § 32.27(c)(3), "All services received by a carrier from its affiliate(s) that exist solely to provide services to members of the carrier's corporate family shall be recorded at fully distributed cost."

In addition, according to 47 C.F.R. § 64.901(b)(iii), "When neither direct nor indirect measures of cost allocation can be found, the cost category shall be allocated based upon a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and nonregulated activities."

Cause

The Beneficiary has not developed an appropriate underlying cost allocation methodology and adequate document retention policies and procedures to support the common cost allocations, including management fees, between the Beneficiary and its affiliates and across accounts.

Effect

The exceptions identified above have an impact on HCL, LSS and ICLS disbursements. The monetary impact of this finding relative to disbursements made from the USF for the HCP for the twelve-month period ended June 30, 2007 is estimated as follows:

- HCL disbursements calculated in the 2004 and 2005 data submissions were approximately $54,720 higher than they would have been had amounts been reported properly[2].
- LSS disbursements calculated in the 2005 data submission were approximately $17,508 higher than they would have been had amounts been reported properly.
- ICLS disbursements calculated in the 2004 data submission were approximately $148,080 higher than they would have been had amounts been reported properly.

Recommendation

The Beneficiary should document a comprehensive cost allocation process, create controls around it, and implement in accordance with the Part 32 and Part 64 Rules and Regulations.

Beneficiary Response

The Beneficiary agrees that it did not retain documentation to support the allocation of executive compensation costs charged by the parent company to the Beneficiary and its affiliates, and the allocation of those costs among the Beneficiary's accounts in 2004 and 2005. During that period, there were personnel changes in the positions responsible for maintenance of such documentation and for the Beneficiary's accounting processes.

However, the Beneficiary does not agree that the general allocation percentages developed by KPMG using a general allocator accurately reflects the actual management fee allocation for 2004 and 2005. The Beneficiary

[2] Monetary impacts resulting from adjustments to Executive Expense (Account 6710) and General and Administrative Expense (Account 6720), and the related impacts on Operating Income Tax Expense (Account 7200), were reported as zero for 2004 and 2005 HCL disbursements. Exceptions noted for 2004 and 2005 reduced Executive Expense (Account 6710) and General and Administrative Expense (Account 6720) amounts reported on the HCL Forms to amounts that remained above the cap level which resulted in zero impact to HCL disbursements.

further disagrees that the compensation costs allocated to it were improper. As a small family-owned telephone company, members of the family management team were responsible for duties typically assigned to employees, such as central office design and construction, billing and collection, customer service, interexchange facility design and approval, and accounting and finance work. Thus, the general allocator would not accurately reflect the actual allocations of executive compensation costs. The Beneficiary notes that the actual activities undertaken by executives on behalf of the Beneficiary resulted in lower amounts being allocated than the general allocator methodology.

In 2008, the Beneficiary and the parent company terminated the management agreement. The management structure was decentralized, and the Beneficiary now employs its General Manager and Director directly. These personnel directly assign each hour of work via bi-weekly time sheets and are paid directly by the Beneficiary. The Beneficiary has continued to operate in this manner, and will continue to enhance the policies and procedures governing expense classification for management compensation. Since 2008, the Beneficiary has operated using a cost allocation methodology that is consistent with the FCC's rules and has established appropriate documentation retention policies and procedures.

4. HC-2009-FL067-F04: Non-regulated MBO Aviation Expenses

Condition

KPMG reviewed the reasonableness of MBO Aviation expenses totaling $315,354 in 2004 and $300,266 in 2005. For 2004 and 2005, 11 out of 26 flights totaling $127,363, and 9 out of 21 flights totaling $133,431, respectively, were incorrectly recorded to Executive Expense (Account 6711) and should have been recorded to a non-regulated account or allocated to another affiliate. Results are based on a flight summary prepared by the Beneficiary which describes the business purpose, attendees, and amounts related to all flights purchased during 2004 and 2005. KPMG detail tested two sample invoices which detail costs associated with two out of the 47 trips taken in 2004 and 2005 and discussed and reviewed additional analysis performed by the Beneficiary.

Criteria

According to 47 C.F.R. § 32.14(c), "When a regulated activity involves the common or joint use of assets and resources in the provision of regulated and nonregulated products and services, companies shall account for these activities within the accounts prescribed in this system for telephone company operations. Assets and expenses shall be subdivided in subsidiary records among amounts solely assignable to nonregulated activities, amounts solely assignable to regulated activities, and amounts related to assets used and expenses incurred jointly or in common, which will be allocated between regulated and nonregulated activities."

In addition, according to 47 C.F.R. § 64.901(b)(iii), "Costs which cannot be directly assigned to either regulated or nonregulated activities will be

described as common costs. Common costs shall be grouped into homogeneous cost categories designed to facilitate the proper allocation of costs between a carrier's regulated and nonregulated activities. Each cost category shall be allocated between regulated and nonregulated activities in accordance with the following hierarchy: (iii) When neither direct nor indirect measures of cost allocation can be found, the cost category shall be allocated based upon a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and nonregulated activities."

Cause

The Beneficiary does not have effective policies and procedures to ensure the complete and accurate allocation of common aircraft-related costs between regulated and non-regulated activities.

Effect

The exceptions identified above have an impact on HCL, LSS and ICLS disbursements. The monetary impact of this finding relative to disbursements made from the USF for the HCP for the twelve-month period ended June 30, 2007 is estimated as follows:

- HCL disbursements were not impacted[3].
- LSS disbursements calculated in the 2005 data submission were approximately $5,547 higher than they would have been had amounts been reported properly.
- ICLS disbursements calculated in the 2004 data submission were approximately $21,560 higher than they would have been had amounts been reported properly.

Recommendation

The Beneficiary should enhance policies and procedures governing common cost allocations between regulated and non-regulated activities, and its retention of supporting documentation in support of such allocations in accordance with the Part 32 and Part 64 Rules and Regulations.

Beneficiary Response

The Beneficiary agrees that it lacked certain specific paperwork and back-up documentation that KPMG requested to demonstrate the regulated purpose of certain flights. However, the Beneficiary disagrees with KPMG's finding regarding the allocation of costs relating to certain individual flights within the MBO Aviation expenses. The following provides further explanation regarding the flights with which the Beneficiary disagrees:

[3] Monetary impacts resulting from adjustments to Executive Expense (Account 6710) and General and Administrative Expense (Account 6720), and the related impacts on Operating Income Tax Expense (Account 7200), were reported as zero for 2004 and 2005 HCL disbursements. Exceptions noted for 2004 and 2005 reduced Executive Expense (Account 6710) and General and Administrative Expense (Account 6720) amounts reported on the HCL Forms to amounts that remained above the cap level which resulted in zero impact to HCL disbursements.

- The Beneficiary disagrees that flights for trip numbers 1, 2, 11, 23, 24, 33 and 38 were entirely unregulated expenses. These trips related in part to the regulated business, and thus, a portion of these costs were justifiably recorded to regulated accounts. The business conducted on these trips related to the operations of multiple lines of business, and thus, KPMG should have allowed at least some portion of the expense to be allocated to regulated accounts.

- The Beneficiary disagrees that flights for trip numbers 36 and 47 were unregulated expenses. Attendance at vendor meetings and presentations that related to equipment that is for the regulated network should be treated entirely as expenses of the regulated business.

Since the 2004/2005 audit period, the Beneficiary has disallowed use of the MBO Aviation aircraft altogether. The Beneficiary has also changed its procedures for reimbursement of travel costs and no longer allows reimbursement of executive travel and entertainment expenses by members of the Beneficiary's management team.

5. HC-2009-FL067-F05: <u>Misclassification of Payroll Hours</u>

Condition

Labor hours for two out of ten employees selected for payroll testing were inappropriately classified in 2004 and 2005 as follows:

- A Marketing Manager recorded 1,152 hours and 1,763 hours, in 2004 and 2005 respectively, representing $30,605 and $56,187, respectively, in payroll expense, to Digital Electronic Switching Expense (Account 6212) and should have recorded these hours to Marketing Expense (Account 6610).
- A Broadband Technician recorded 1,941 hours and 1,645 hours, in 2004 and 2005 respectively, representing $49,309 and $39,704, respectively, in payroll expense, to Digital Electronic Switching Expense (Account 6212) and should have recorded these hours to a non-regulated account.

Criteria

According to 47 C.F.R. § 32.6212(a)-(c), "This account shall include expenses associated with digital electronic switching. Digital electronic switching expenses shall be maintained in the following subaccounts: 6212.1 Circuit, 6212.2 Packet. This subaccount 6212.1 Circuit shall include expenses associated with digital electronic switching equipment used to provide circuit switching. This subaccount 6212.2 Packet shall include expenses associated with digital electronic switching equipment used to provide packet switching."

In addition, according to 47 C.F.R. § 64.901(b)(iii), "Costs which cannot be directly assigned to either regulated or nonregulated activities will be described as common costs. Common costs shall be grouped into homogeneous cost categories designed to facilitate the proper allocation of costs between a carrier's regulated and nonregulated activities. Each cost category shall be allocated between regulated and nonregulated activities in

accordance with the following hierarchy: (iii) When neither direct nor indirect measures of cost allocation can be found, the cost category shall be allocated based upon a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and nonregulated activities."

Cause

The Beneficiary does not have effective policies and procedures to detect payroll hours that are charged to inappropriate Part 32 expense accounts or to regulated instead of non-regulated accounts.

Effect

The exceptions identified above have an impact on HCL, LSS and ICLS disbursements. The monetary impact of this finding relative to disbursements made from the USF for the HCP for the twelve-month period ended June 30, 2007 is estimated as follows:

- HCL disbursements calculated in the 2004 and 2005 data submissions were approximately $13,460 higher than they would have been had amounts been reported properly.
- LSS disbursements calculated in the 2005 data submission were approximately $10,169 higher than they would have been had amounts been reported properly.
- ICLS disbursements calculated in the 2004 data submission were approximately $3,007 lower than they would have been had amounts been reported properly.

Recommendation

The Beneficiary should enhance policies and procedures governing the review and approval of payroll hours coded by employees to ensure that appropriate accounts and regulated versus non-regulated activities are charged in accordance with the Part 32 and Part 64 Rules and Regulations.

Beneficiary Response

The Beneficiary agrees that the classifications of the payroll hours for the two employees identified were assigned incorrectly. The Beneficiary has established policies and procedures to assure the accurate time coding and appropriate time documentation of all employees, including training for employees regarding proper time coding and comprehensive procedures for reviewing timesheets.

CONFIDENTIAL AND PROPRIETARY
Confidential Treatment Requested Pursuant to 47 C.F.R. 54.711(b)

Cross Telephone Company, L.L.C.

ATTACHMENT E

Declaration of V. David Miller, II

DECLARATION OF V. DAVID MILLER II
IN SUPPORT OF CROSS TELEPHONE COMPANY L.L.C.

1. I, V. David Miller II, am President of Cross Telephone Company L.L.C. ("Cross" or the "Company"). I have more than 35 years of experience in the telecommunications industry. I have worked for Cross for 35 years.

2. I am providing this Declaration in support of Cross' Request for Review of Finding No. 1 of the Final Audit Report issued November 6, 2018 ("Audit Report"). The audit, conducted by Moss-Adams LLP (the "Auditor") on behalf of the Universal Service Administrative Company ("USAC"), audited, Cross' compliance with the Federal Communications Commission's ("Commission") rules governing the federal universal service high cost program ("HCP") support mechanism during calendar years 2010-2014 (the "Audit"). The information in this Declaration is to the best of my knowledge and belief.

BACKGROUND

3. Cross is a limited liability company formed under the laws of the State of Oklahoma and has a principal place of business located at 704 Third Avenue, Warner, Oklahoma 74469. The Company is an incumbent local exchange carrier providing local exchange and other telephone services throughout the state of Oklahoma. The Company's customer base includes a mix of business, residential, enterprise and government customers. Cross provides exchange service to subscribers utilizing a mix of its own facilities and services purchased from its affiliates and third parties.

4. Cross receives support from the HCP to aid the Company in making communications service affordable to subscribers in its territory. Cross used the HCP funds,

associated with Audit Finding No. 1, to provide modern voice services and broadband services to the Company's subscribers. Cross would not be able to recover the HCP funds from its subscribers.

CROSS' PURCHASE OF DS1 TRANSPORT SERVICES

5. During the 2012 – 2016 time period covered by Audit Finding No. 1, Cross purchased DS1 transport services to transport its traffic between Cross Telephone's switch in Warner, Oklahoma and an interexchange carrier meet point in Tulsa, Oklahoma. Cross Telephone has never owned the facilities necessary to transport its traffic between Warner and Tulsa. Prior to purchasing the DS1 transport service from MBO, Cross purchased similar DS1 transport services from other carriers such as Southwestern Bell Telephone ("SWBT", now AT&T) pursuant to SWBT's tariff.

6. In the late 1990s, MBO constructed a fiber network and used it to offer services to other carriers. MBO sold services to other customers and other carriers are receiving services using the same facilities from MBO. Cross Telephone subsequently began purchasing DS1 transport services from MBO. For the DS1 transport services purchased from MBO, Cross pays a flat monthly fee per DS1 on a month-to-month basis and Cross' service orders may change based on the Company's particular service demands for each month.

7. Cross' purchase of DS1 transport service from MBO initially was governed by a General Contract for Services which was replaced, in 2008, by a Master Services Agreement ("MSA") setting forth the terms and conditions governing Cross' purchase of the transport service. The MSA made clear that Cross Telephone was purchasing services, not leasing facilities, from MBO and that Cross Telephone was not granted title to any of MBO's equipment and facilities in connection with purchase of the DS1 transport service. Cross' purchase of DS1

transport service from MBO did not involve the sale of Cross' assets to MBO or the subsequent lease-back of those assets. Cross did not sell any assets to MBO.

MBO REPORTING OF DS1 TRANSPORT SERVICE REVENUES

8. MBO reported the revenues from the DS1 Transport services that Cross Telephone purchased on line 305.1 of the FCC Form 499A as "[r]evenues from *providing local services* that involve dedicated circuits, private switching arrangements, digital subscriber lines, and/or predefined transmission paths." MBO did not report those service revenues on Line 418 as revenues from the "lease of transmission facilities that are not provided as part of telecommunications service."

CROSS USAC AUDIT AND DS1 TRANSPORT SERVICE EXPENSE REPORTING

9. Cross Telephone has consistently reported its DS1 transport service payments to MBO as expenses for HCP support purposes. Information about the Company's reporting methodology was provided to USAC in the course of a 2009 audit reviewing Cross Telephone's HCP reporting in 2004 and 2005. In 2009, KPMG, on behalf of USAC, conducted an Improper Payment Information Act performance audit of Cross' participation in the HCP (the "2009 Audit"). The 2009 Audit reviewed, among other information, Cross' methodology for reporting expenses, associated with DS1 transport service purchased from MBO, for purposes of HCP reporting. The only statement in the 2009 audit findings regarding the DS1 transport services Cross Telephone purchased from MBO was included in a finding which also addressed unrelated regulated and non-regulated cost allocations. Cross Telephone purchased the same DS1 transport services from MBO in 2012–2016 as it purchased for 2004–2005 and reported the expenses in the same manner during both time periods.

10. Among other information, Cross provided to KPMG and USAC, information regarding Cross' purchase of DS1 transport service from MBO, including copies of the General Contract for Services and MSA, and Cross' methodology for reporting related expenses for purposes of the HCP. In audit materials provided to Cross, neither KPMG nor USAC expressed any objection to Cross' reporting methodology, aside from identifying a minor capacity miscount. The 2009 Audit finding regarding the DS1 transport services noted that, absent the service miscount, Cross would have been eligible to receive more HCP support than Cross had received.

11. During the time period covered by Finding No. 1, Cross Telephone participated in the NECA tariff and submitted annual cost studies to NECA. The Company's cost studies treated its affiliate DS1 transport service purchase expenses as expenses and NECA never rejected Cross Telephone's cost studies based on that reporting.

I hereby declare under penalty of perjury that the foregoing declaration is true and correct to the best of my knowledge and belief.

Dated this 3rd day of January, 2019

V. David Miller II

President

CONFIDENTIAL AND PROPRIETARY
Confidential Treatment Requested Pursuant to 47 C.F.R. 54.711(b)

Cross Telephone Company, L.L.C.

ATTACHMENT F

MBO Master Service Agreement

Agreement No. _____

MBO MASTER SERVICE AGREEMENT

This Master Services Agreement ("Agreement") is made this _____ day of _____, _____, by and between **MBO Video, L.L.C.** ("MBO or Provider"), with its principal place of business at One Main Street, Earlsboro, Oklahoma 74840, and **Cross Telephone Company, L.L.C.** ("Customer"), with its principal place of business at 704 3rd Avenue, Warner, OK 74469, for the provision of services, subject to this Agreement and as set forth in this Agreement.

Article 1. Agreement of the Parties

1.1 Services. Customer may order from MBO services which may consist of either or both MBO' Services or Third Party Services, (sometimes referred to herein collectively or individually, as the "Service(s)"). "MBOs' Services" shall consist of those Services as indicated in Table A (check as applicable), but does not include any Services which constitute Third Party Services as defined below in Section 1.2. All Services shall be provided upon the terms and conditions that are set forth in this Agreement, including any applicable Customer Service Purchase Order. All Services are subject to availability and approval of Customer's credit by MBO.

Table A			
Schedule 1	☐ Private Line Service	Schedule 6	☐ Network Timing Services
Schedule 2	☐ Optical Wave Service	Schedule 7	☐ Managed Services
Schedule 3	☐ ATM Service	Schedule 8	☐ Network Interconnection
Schedule 4	☐ Dedicated Internet Service	Schedule 9	☐ Collocation Service
Schedule 5	☐ Video Transport	Schedule 10	☐ Web Hosting Service

1.2 Third Party Services. Upon request by the Customer, MBO may arrange on behalf of Customer for services to be provided by a third party ("Third Party Services"). For instance, Third Party Services may include Local Access Services, third party provided interexchange services, and third party provided international service. Local Access Services shall be arranged pursuant to Article 4 of this Agreement. When Customer requests international service, MBO may arrange for the foreign end of the Service or for a portion of the foreign end of the Service to be provided by a third party carrier licensed in the relevant foreign point. In some cases, MBO may be unable to, and Customer may be required to, arrange the foreign end of such Service with a foreign carrier. Although this Agreement governs the terms of MBO' arrangement of Third Party Service, the service level parameters and related warranties (if any), pricing, surcharges, outage credits, required commitments, termination liability, and other service-specific terms of the Third Party Service shall be those of the provider of the Third Party Services ("Third Party Provider").

Article 2. Effective Date and Term

2.1 Term of Agreement. This Agreement shall become effective on the date first written above ("Effective Date") and shall continue for 180 days from the Effective Date (Term) and shall automatically terminate unless Customer has entered into a "Client Service Purchase Order" as provided for herein or unless the Parties mutually agree to extend the Term in writing.

2.2 Client Service Purchase Order Term. Each Client Service Purchase Order placed under this Agreement shall have its own term, as indicated on such Client Service Purchase Order ("Service Term"). At the end of the Service Term for any Client Service Purchase Order (as defined in Section 3.1.a), such Client Service Purchase Order shall continue on a month-to-month basis ("Extension Period") unless either party gives written notice to the other that the circuit(s) described in such Client Service Purchase Order shall be disconnected, such notice to be delivered at least sixty (60) calendar days before the end of the Service Term, or if during the Extension Period, then upon at least thirty (30) calendar days' written notice. Customer's charges, as set forth in this Agreement, for Services provided by MBO during the Service Term shall continue to apply to Customer's Service throughout any Extension Period, unless modified pursuant to the terms of this Agreement. Unless Customer is in default, any Service being provided at the time of termination of this Agreement shall continue upon the terms and conditions of this Agreement until end of the Service Term or any applicable Extension Period Service as specified in the applicable Client Service Purchase Order or until such Client Service Purchase Order is terminated pursuant to the second sentence of this Section 2.2; provided, however, that Customer may not order any new Service until Customer and MBO have entered into a new agreement or mutually agreed in writing to extend this Agreement.

Article 3. Ordering and Provisioning of Service

3.1 Client Service Purchase Orders

a. All Services shall be requested on MBO' Client Service Purchase Order forms in effect from time to time or on Customer's forms which have been previously accepted in writing by MBO ("Client Service Purchase Order(s)"). Client Service Purchase Orders shall be transmitted and processed in accordance with the terms and conditions of this Agreement as well as any procedures set out in the applicable Customer Service Purchase Order for a specific Service. MBO shall accept any Client Service Purchase Order under this Agreement that complies with the terms and conditions set forth herein, subject to availability and credit approval at the time Customer places such Client Service Purchase Order.

b. A Client Service Purchase Order is deemed accepted (subject to availability) by MBO when MBO' Service Delivery department transmits a copy of the signed Client Service Purchase Order with the TUA Date and Effective Billing Date, as specified in Section 3.2, to Customer indicating that Customer's order is being processed by MBO.

c. When a Client Service Purchase Order is placed, Customer will designate: (i) a requested start date ("Requested Start Date") for the Service; (ii) the desired term of the Service; (iii) the specific city pairs, if applicable; (iv) the bandwidth, if applicable; and (v) any other information necessary to enable MBO to provide the Service. MBO will make reasonable efforts to meet Customer's Requested Start Date. In the event that MBO is unable to meet Customer's Requested Start Date, MBO will notify Customer of the date when MBO believes the Service will be available and Customer's Requested Start Date will be changed to reflect the number of days of delay or advance, as appropriate. Failure of MBO to deliver by Customer's Requested Start Date shall not constitute a default under this Agreement and MBO shall not be liable to pay to Customer any penalties or damages for MBO' failure to meet Customer's Requested Start Date.

d. Any terms or conditions contained in Customer's acknowledgement or Client Service Purchase Order or elsewhere which conflict with, are different from, or are in addition to, the terms and conditions in this Agreement are hereby objected to by MBO and shall not constitute part of this Agreement. No action by MBO (including, without limitation, provision of Services to Customer pursuant to such Client Service Purchase Order) shall be construed as binding or estopping MBO with respect to such term or condition

3.2 Turn Up Acknowledgement. MBO will issue to Customer notice that Service is available ("Turn Up Acknowledgement" or "TUA"). The TUA will indicate that all the relevant Services ordered through MBO has been tested by MBO and that the MBO' Service meets or exceeds the Technical Specifications set forth in the relevant Customer Service Purchase Order. The TUA will also set forth the date Customer's Service was available for use by Customer and upon which MBO shall commence charging for the Service ("Effective Billing Date").

3.3 Service Acceptance. Customer shall be deemed to have accepted Service and MBO shall begin billing for the Service as of the Effective Billing Date, provided that, if Customer notifies MBO' Service Delivery Department in writing within three (3) business days of the Effective Billing Date that MBO' Service is in material non-compliance with the applicable Technical Specifications and if, upon investigation, such material non-compliance is due solely to MBO fault, then MBO shall correct the non-compliance and make the appropriate adjustment to Customer's billings under this Agreement. The occurrence of any such non-compliance shall not constitute a default under this Agreement and MBO shall not be liable to pay to Customer any penalties or damages resulting from any such non-compliance. Charges for Service begin accruing upon Effective Billing Date, regardless of whether Customer is actually using the Services, or is ready to test and accept the Services.

Article 4. Local Access Services

4.1 Local Access Services. Upon request by the Customer, MBO may obtain "Local Access Service" for Customer, which is defined as the telecommunications facilities or services connecting a Customer-designated termination point to a point of presence ("POP") designated by MBO. The term Local Access Service, as used throughout this Agreement, may include both domestic U.S. and foreign Local Access Service. Customer shall execute a Letter of Agency, in a form provided by MBO, authorizing MBO to interact directly with the Local Access Service provider(s) to obtain the Local Access Service. Customer shall pay all charges including, without limitation, monthly charges, usage charges, installation charges, non-recurring charges, or applicable termination/cancellation charges, of the Local Access Service provider(s).

4.2 MBO' Provisioning, Testing, and Charging for Local Access Services. For Local Access Services ordered by MBO, MBO shall provision and conduct the initial testing of an interconnection between the MBO' Service set forth in the Client Service Purchase Order and the Local Access Service. MBO shall coordinate the installation of the Local Access Service with the MBO' Service. Local Access Service charges shall accrue at the then-current tariff rate (or the standard published rate, if there is no tariff rate) of the Local Access Service provider. If the applicable rate for Local Access Service is changed by the Local Access Service provider, such changes will be passed through to, and be borne by, Customer. In the event MBO' Services are not ready at the same time as the MBO' ordered Local Access Service, MBO will not begin billing Customer for such Local Access Services until the related MBO' Services are turned up.

4.3 Customer Ordered Local Access. Customer may, in conformance with MBO' policies on third parties providing connectivity into a MBO' POP, order its own Local Access Services from a vendor who has established entrance facilities in MBO' POP ("Approved Vendor") In the event Customer desires to order Local Access Services from someone other than an Approved Vendor, Customer must get MBO' prior written permission. In such event, the Local Access Service provider shall directly bill Customer for such Services. MBO may charge Customer for any associated entrance facility or mileage charges if it provides Carrier Facility Assignment ("CFA") to Customer. Customer shall ensure that the Customer-ordered Local Access Services are turned up at the same time as the MBO' Services. If the Customer-ordered Local Access Services are not ready as of the Effective Billing Date, Customer shall nonetheless be obligated to pay for MBO' Services as of the Effective Billing Date.

Article 5. Payment Terms and Charges

5.1 Monthly Billing. MBO provides and charges for Service on a monthly basis in U.S. dollars. Fixed monthly recurring charges are billed one (1) month in advance. Unless MBO requires payment in advance, charges for installation charges and other non-recurring charges shall be billed in MBO' next invoice cycle and are due and payable in accordance with Section 5.2 below.

5.2 Due Date and Invoice All amounts stated on each monthly invoice are due and payable in U.S. dollars upon receipt and are considered delinquent thirty (30) calendar days from the date of the invoice ("Delinquency Date") Customer agrees to remit payment via Automated Clearinghouse ("ACH") or wire transfer to MBO in care of _____, Account #_____ or such other bank or account as MBO may in writing direct Customer to remit payment pursuant to the notice provisions of this Agreement. In the event Customer fails to make full payment of undisputed amounts by the Delinquency Date, Customer shall also pay a late fee in the amount of the lesser of (i) one and one-half percent (1½ %) per month or (ii) the maximum lawful monthly rate under applicable state law, of the unpaid balance which amount shall accrue from the date of the invoice. Customer acknowledges and understands that all charges are computed exclusive of any Additional Charges (as defined in Section 5.8). Such Additional Charges shall be paid by Customer in addition to all other charges provided for herein.

5.3 Adjustments. MBO may make billing adjustments for a period of two (2) years after the Date of an invoice, or two (2) years after the date a Service is rendered, whichever is later

5.4 Billing Disputes

a. Notwithstanding the foregoing, amounts charged for MBO' Services which are reasonably disputed by Customer (along with late fees attributable to such amounts) shall apply but shall not be due and payable for a period of thirty (30) calendar days following the Delinquency Date, provided Customer: (i) pays all undisputed charges on or before the Delinquency Date, and (ii) presents a written statement of any billing discrepancies to MBO in reasonable detail together with appropriate supporting documentation on or before the Delinquency Date of the invoice in question, and (iii) negotiates in good faith with MBO for the purpose of resolving such dispute within said thirty (30) calendar day period.

b. In the event such dispute is mutually agreed upon and resolved in favor of MBO, Customer agrees to pay MBO the disputed amounts together with any applicable late fees within five (5) business days of the resolution (the "Alternate Delinquency Date"). In the event such dispute is mutually agreed upon and resolved in favor of Customer, Customer will receive a credit for the disputed charges and no late fees shall apply

c. In the event MBO has responded to Customer's dispute in writing and the parties fail to mutually resolve or settle the dispute within such thirty (30) calendar day period (unless MBO has agreed in writing to extend such period), all disputed amounts together with the late fees shall become due and payable on the thirtieth (30th) day following the Delinquency Date, and this provision shall not be construed to prevent Customer from pursuing any legal remedies.

d MBO shall not be obligated to consider any Customer notice of billing discrepancies which are received by MBO after the Delinquency Date. This right to dispute applies only to MBO' Services provided to Customer and not to any dispute Customer may have with its End User or with respect to Third Party Services. To the extent requested by Customer and to the extent Customer has reasonable grounds for such dispute, MBO' will act on Customer's behalf to dispute any charges for Third Party Services provided that, such dispute shall be subject to the Third Party Provider's rules regarding disputed amounts and not the provisions of this Section 5 4 and provided further, that, Customer shall indemnify MBO against any cost, expenses or charges incurred by MBO as a result of its acting on behalf of Customer to dispute charges for Third Party Services

5.5 Validation of Credit MBO reserves the right to determine the creditworthiness of Customer through available verification procedures or sources and Customer hereby consents to MBO obtaining credit information regarding the Customer, its owners and affiliates. If at any time, Customer presents, in MBO' reasonable discretion, an undue risk of non-payment, or if Customer fails to comply with the payment terms of this Agreement or any Client Service Purchase Order, MBO may require a deposit or other forms of security for payment. In determining whether a Customer presents an undue risk of nonpayment, MBO may consider, but is not limited to, the following factors: (i) the Customer's payment history (if any) with MBO, (ii) the Customer's ability to demonstrate adequate ability to pay for the Service, (iii) credit and related information provided by Customer; (iv) credit and related information lawfully obtained from third parties or publicly available, (v) information relating to Customer's management, owners and affiliates (if any) and (vi) Customer's monthly recurring charges exceeding Customer's established credit limit.

5.6 MBO's Right to Assurance

a. If at any time there is a material adverse change in Customer's creditworthiness or a material adverse change in Customer's financial position, then in addition to any other remedies available to MBO, MBO may elect, in its sole discretion, to demand reasonable assurance of payment from Customer, including among others the posting of a deposit and executing an agreement with MBO regarding the use of any such deposit ("Deposit Agreement"), such Deposit Agreement to be in form and substance acceptable to MBO.

b A material adverse change in Customer's creditworthiness shall include, but not be limited to: (i) Customer's default of its obligations to MBO under this or any other agreement with MBO; (ii) failure of Customer to make full payment of charges due hereunder on or before the Delinquency Date on two (2) or more occasions during any period of twelve (12) or fewer months; (iii) acquisition of Customer (whether in whole or by majority or controlling interest) by an entity which is insolvent or which is subject to bankruptcy or insolvency proceedings, or which owes past due amounts to MBO or any MBO affiliate, or which is a materially greater credit risk than Customer; or (iv) Customer's being subject to or having filed for bankruptcy or insolvency proceedings or the legal insolvency of Customer.

c. A material adverse change in Customer's financial position shall include, but not be limited to: (i) a decrease in net worth or working capital of five percent (5%) or greater during any calendar quarter; or, (ii) a negative net worth or working capital. If Customer's financial statements are not public information or have not otherwise been made available to MBO, then, upon MBO' request, Customer shall provide its most current audited and unaudited financial statements.

d. If Customer has not provided MBO with (i) its financial statements within ten (10) calendar days of MBO' request therefore or (ii) in the event of a MBO demand for assurance of payment, assurance satisfactory to MBO within ten (10) calendar days of MBO' notice of demand for such assurance, then, in addition to any other remedies available to MBO, MBO shall have the option, in its sole discretion, to exercise one or more of the following remedies: (i) cause the start of any Service described in any previously executed Client Service Purchase Order to be delayed pending receipt of such financial statements or of the satisfactory assurance; or (ii) decline to accept a Client Service Purchase Order or other requests from Customer to provide Service; or (iii) suspend all or any portion of the Service then being provided after giving Customer five (5) calendar days prior written notice If Customer provides satisfactory assurance during the five (5) calendar day notice period, MBO will not suspend any Service.

5.7 Charges for Services. All charges for Services shall be those in effect as of the date MBO' accepts the Client Service Purchase Order. Customer shall be liable for all charges (recurring and non-recurring) for Services provided by MBO and by Third Party Providers. Additionally, Customer shall incur charges in those circumstances in which extraordinary costs and expenses are generated by Customer and reasonably incurred by MBO beyond those normally associated with the Services, including but not limited to, the following: (a) Customer's request to expedite Service availability to a date earlier than MBO's standard installation interval or a previously customer requested Start Date; (b) Service redesign or other activity occasioned by receipt of inaccurate information from Customer; (c) reinstallation charges following any suspension of the Service for cause by MBO; and (d) Customer's request for use of routes or facilities other than those selected by MBO for provision of the Service.

5.8 Additional Charges.

a. If any sales taxes, valued added taxes or other charges or impositions are asserted against MBO after, or as a result of, Customer's use of Services by any local, state, national, international, public or quasi-public governmental entity or foreign government or its political subdivision, including without limitation, any tax or charge levied to support the federal Universal Service Fund contemplated by the Telecommunications Act of 1996, or any state or foreign equivalent ("Additional Charges"), Customer shall be solely responsible for such Additional Charges. Customer agrees to pay any such Additional Charges and hold MBO harmless from any liability or expense associated with such Additional Charges.

b. If Customer has been granted a tax exemption for taxes in a given jurisdiction, then MBO shall not bill Customer for such taxes if Customer provides MBO with written verification of such tax exemption acceptable to MBO and properly issued by the relevant taxing jurisdiction. Service provided hereunder shall also not be subject to contribution to any universal service program if Customer provides MBO with written verification or exemption certificate, acceptable to MBO for the relevant jurisdiction, that the Service will be resold by Customer and that the revenues from such resale shall be subject to the universal service program's contribution requirements. If any jurisdiction, in conjunction with any universal service program, assesses any charges against, or seeks any contributions from, MBO in connection with any of the Service provided hereunder, Customer shall indemnify MBO against any such assessments or contributions.

Article 6. Suspension and Termination

6.1 Suspension Of Service

a. Except for amounts disputed by Customer in accordance with Section 5.4 Billing Disputes, in the event payment in full is not received from Customer on or before the Delinquency Date, MBO shall have the right: (i) upon providing a minimum of ten (10) calendar days written notice (the "Suspension Notice"), to suspend or block, at any time after such Suspension Notice, all or any portion of all the Services then being provided to Customer; and (ii) to immediately place any pending Client Service Purchase Orders on hold, and to decline to accept any new Client Service Purchase Orders or other requests from Customer to provide Service commencing on the day that MBO issues the Suspension Notice to Customer. If MBO receives the entire past due amount within the ten (10) calendar day notice period, then Customer's Service shall not be suspended. MBO may continue such suspension until such time as Customer has paid in full all charges then due, including any reinstallation charges and/or late fees as specified herein. Following such payment, MBO shall reinstate Customer's Services subject to MBO' Right to Assurance as provided above in Section 5.6.

b. Suspension of Services as set forth in this Section shall not affect Customer's obligation to pay for the Services. Notwithstanding anything to the contrary in this Agreement, if Customer has agreed to a Revenue Commitment, any suspension of Service by MBO shall not relieve Customer of its obligations to pay the Revenue Commitment.

6.2 Termination of Service.

a. MBO may, without incurring any liability, cancel any Service prior to its commencement or disconnect such Service, in whole or in part, immediately and without notice if MBO deems that such action is necessary to prevent or to protect against fraud or to otherwise protect its personnel, agents, facilities or Services under any of the following circumstances:
   (i) if Customer refuses to furnish or provides false information to MBO regarding the Customer's identity, address, credit-worthiness, past or current use of Service, or its planned use of Service;
   (ii) if the Customer or End User is using the Service in violation of any applicable law or regulation; or
   (iii) for failure of Customer to comply with Section 8.7a Representations;

b. In addition to its other termination rights hereunder, and with respect to all Services, MBO may immediately disconnect any Services in whole or in part if MBO determines that such Services violate any law, statute, or ordinance, including the Communications Act of 1934 (as amended), or that the imposition of any statute, or promulgation of any rule, regulation, or order of the Federal Communications Commission or other governing body makes MBO' performance under this Agreement commercially impracticable

6.3 Termination of Agreement.

a. Termination of Agreement For Cause. Except for an event of non-payment by Customer hereunder which is addressed in subsection (b) below, either party may terminate this Agreement if the other is in default of any material obligation contained herein, which default has not been cured within thirty (30) calendar days following the receipt of notice of such default setting forth the specifics of such default. Notwithstanding the foregoing, the failure of any particular Service or Services to comply with the Technical Specifications set forth individually for each Service in the attached Customer Service Purchase Orders shall not be deemed a default by MBO, but may obligate MBO to provide Customer with Outage Credits, if applicable under the relevant Customer Service Purchase Order. Termination of this Agreement for cause does not relieve Customer of any obligations to pay MBO for charges accrued for Service which has been furnished up to the time of termination nor does it relieve the Customer of all applicable cancellation and/or disconnection charges. The remedies available to either Party as set forth in this paragraph shall not be exclusive and either Party shall at all times be entitled to all rights available to it under either law or equity.

b Termination of Agreement For Non-payment. In the event any amount payable by Customer has not been received in full by MBO on or before the Delinquency Date (except for amounts disputed by Customer in accordance with Section 5.4 Billing Disputes), MBO shall have the right to terminate this Agreement upon ten (10) calendar days' written notice to the Customer. Termination of this Agreement pursuant to this subsection shall not relieve Customer of any obligations to pay MBO for charges accrued for Service which has been furnished up to the time of termination nor does it relieve the Customer of all applicable cancellation and/or disconnection charges. The remedies available to MBO set forth in this paragraph shall not be exclusive and MBO shall at all times be entitled to all rights available to it under either law or equity.

c. Termination Due To Government Action. Notwithstanding the foregoing, and upon written notice consistent with the mandate put forth by the applicable governmental authority or commission, to the other party, either Customer or MBO shall have the right, without incurring an Early Termination Charge or other liability to the other party, to disconnect the affected portion of any Service, if MBO is prohibited by governmental authority from furnishing or Customer is prohibited from using such portion, or if any material rate or term contained herein and relevant to the affected portion of any Service is substantially changed by order of the highest court of competent jurisdiction to adjudicate the matter, the Federal Communications Commission, or other local, state, federal, or foreign government authority.

6.4 Termination Charges

a Early Termination Charge. If Customer desires to disconnect any Service after installation, Customer may do so by providing written notification to MBO thereof sixty (60) days in advance of the effective date of the disconnection. In the event of such disconnection, Customer shall pay to MBO an "Early Termination Charge" in an amount equal to the monthly recurring charge for such disconnected Service multiplied by the number of months in the relevant Service Term, less the charges for such Service actually paid by Customer through the effective date of the disconnection plus any non-recurring payments not yet paid by Customer together with any termination liability associated with any other Third Party Service.

b. Revenue Commitment Termination Charge. If Customer has made a Revenue Commitment, the rates for Services and associated discounts are based on Customer's agreement to purchase Service for the entire Term of the Agreement. If Customer terminates the Agreement or breaches the Agreement prior to the end of the Term of the Agreement, Customer shall pay to MBO a "Revenue Commitment Termination Charge" in an amount equal to (i) Customer's monthly Revenue Commitment multiplied by the number of months in the Term of this Agreement, less the charges for Applicable Services (as defined in the Revenue Commitment Exhibit if applicable) actually paid by Customer through the effective date of termination and (ii) any non-recurring payments not yet paid together with any termination liability associated with Local Access Service or any other Third Party provided service.

c. Liquidated Damages. Customer agrees that the actual damages in the event of a disconnection pursuant to this Section 6.4 would be difficult or impossible to ascertain, and that the Early Termination Charges and Revenue Commitment Termination Charges, if any, in this Section 6.4 are intended to establish liquidated damages only and are not intended as penalties.

Article 7. Limitation of Liability

IN THE EVENT OF ANY BREACH OF THIS AGREEMENT OR ANY FAILURE OF THE SERVICES, WHATSOEVER, NEITHER MBO NOR ANY MBO' PROVIDER (AS DEFINED IN SECTION 8.4 INDEMNITY) SHALL BE LIABLE FOR ANY DIRECT, INDIRECT, CONSEQUENTIAL, SPECIAL, ACTUAL, INCIDENTAL, PUNITIVE OR ANY OTHER DAMAGES, OR FOR ANY LOST PROFITS OF ANY KIND OR NATURE WHATSOEVER, EVEN IF MBO OR THE MBO' PROVIDER HAS BEEN ADVISED OF THE POSSIBILITY OF SUCH DAMAGE OR LOSS.

Article 8. General

8.1 Exclusive Remedies. Except as otherwise specifically provided for herein, the remedies set forth in this Agreement comprise the exclusive remedies available to either party at law or in equity.

8.2 Warranty and Disclaimer of Warranty. **MBO MAKES NO WARRANTY WITH RESPECT TO THE SERVICE OR ITS PERFORMANCE UNDER THIS AGREEMENT UNLESS EXPRESSLY SET FORTH IN THIS AGREEMENT, INCLUDING ANY CUSTOMER SERVICE PURCHASE ORDER. WITH THE EXCEPTION OF THE EXPRESS WARRANTIES, IF ANY, SET FORTH IN THE CUSTOMER SERVICE PURCHASE ORDER, MBO DISCLAIMS ALL WARRANTIES WHETHER EXPRESS OR IMPLIED INCLUDING WITHOUT LIMITATION THE IMPLIED WARRANTY OF MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE. NO WARRANTY IS MADE OR PASSED ON WITH RESPECT TO ANY THIRD PARTY SERVICES.**

8.3 Compliance with Law. Customer agrees that its use of the Services shall be in accordance, and comply, with all applicable laws, regulations, and rules and that Customer shall obtain all approvals, consents and authorizations necessary to conduct its business and initiate or conduct any transmissions over any facilities covered by this Agreement. MBO reserves the right, exercisable in its sole discretion, to disconnect or restrict any transmission initiated by Customer, if such actions are reasonably appropriate to assure that MBO is not in violation of any civil or criminal law, regulation or rule.

8.4 Indemnity.

a. Customer and MBO shall defend, indemnify and hold harmless the other against and from any and all claims for damage to tangible property or bodily injury, including claims for wrongful death, to the extent that such claim arises out of the negligence or willful misconduct of the respective indemnifying party, its employees, agents, or contractors in connection with this Agreement or the provision of Services hereunder.

b. Customer will defend, indemnify and hold harmless MBO' Providers and their respective officers, directors, employees, contractors and agents against and from any loss, debt, liability, damage, obligation, claim, demand, judgment or settlement of any nature or kind, known or unknown, liquidated or unliquidated, including without limitation, all reasonable costs and expenses incurred including all reasonable litigation costs and attorneys' fees (collectively, "Damages") arising out of, resulting from or based upon any complaint, claim, action, proceeding or suit of any third party, including any governmental authority, (a "Claim"), including any Claim based on Customer's violation of any law or any rule or regulation to the extent that such Claim arises out of alleged negligence or willful misconduct of Customer, its employees, agents, or contractors. For purpose of this subsection, "MBO' Providers" shall mean MBO and any third party or affiliated provider, operator, or maintenance/repair contractor of facilities employed in connection with the provision of Services.

c. The indemnified party shall promptly notify the indemnifying party in writing of any claims which are subject to the terms of this Section 8.4. The indemnified party shall have the right at its own expense to appoint its own counsel who shall be entitled to participate in any settlement negotiations or litigation regarding any matter for which it is entitled to be indemnified hereunder. The indemnifying party shall not agree to any settlement or consent to any decree, order or judgment without obtaining the consent of the indemnified party which consent shall not be unreasonably withheld.

8.5 Force Majeure. If either party's performance of this Agreement or any obligation (other than the obligation to make payments) hereunder is prevented, restricted or interfered with by causes beyond its reasonable control including, but not limited to, acts of God, fire, explosion, vandalism, cable cut, power outage, storm or other similar occurrence including rain fade or other atmospheric conditions, any law, order, regulation, direction, action or request of any government, or of any department, agency, commission, court, bureau, corporation or other instrumentality of any one or more of said governments, or of any civil or military authority, or by national emergencies, insurrections, riots, wars, acts of terrorism, strikes, lockouts or work

stoppages or other labor difficulties, supplier failures, shortages, breaches or delays, then the party that is unable to perform or meet its obligations due to such causes shall be excused from such performance on a day-to-day basis to the extent of such prevention, restriction or interference. The party that is unable to perform or meet its obligations due to such causes shall use commercially reasonable efforts under the circumstances to avoid and remove such causes of non-performance and shall proceed to perform with reasonable dispatch whenever such causes cease. In the event the force majeure event prevents the use of any circuit provided as part of the MBO' Services and such force majeure event continues for a period of sixty (60) days, then either party may disconnect the affected circuit without incurring liability, except for Customer's liability for any charges of a Third Party Provider.

8.6 Proprietary Information.

a. MBO and Customer understand and agree that the terms and conditions of this Agreement and all documents referenced herein (including invoices to Customer for Services provided hereunder) are confidential as between Customer and MBO. Neither Customer nor MBO shall disclose such information to any third party without the prior written consent of the other, except as provided in Section 8.6(c) below.

b. In addition to the matters covered under clause a. above, when confidential information is furnished in a tangible form by one party to the other, the disclosing party shall mark the information in a manner to indicate that it is considered confidential. When information deemed to be confidential is provided orally, the disclosing party shall, at the time of disclosure, clearly identify the information as being confidential and confirm such designation in writing within ten (10) calendar days thereafter. If the disclosing party fails to identify information as confidential, such disclosing party may correct the omission by later notice consisting of a writing or statement, and the receiving party shall only be liable for unauthorized disclosures of such confidential information made subsequent to said notice. All information identified as confidential pursuant to this clause b. shall not be disclosed by the receiving party to any third party without the written consent of the disclosing party, except as provided in Section 8.6(c) below.

c. The party to whom confidential information is disclosed shall have no obligation to preserve the confidential nature of such information if it: (i) was previously known to such party free of any obligation to keep it confidential; (ii) is or becomes publicly available by other than unauthorized disclosure; (iii) is developed by or on behalf of such party independent of any information furnished under this Agreement; or (iv) is received from a third party whose disclosure does not violate any confidentiality obligation. MBO may disclose confidential information regarding its relationship with Customer to commercial lenders who have specifically agreed to hold such information in confidence. In addition, a party may disclose confidential information provided to it by the other party if such disclosure is made pursuant to the requirement or request of a recognized stock exchange or of a governmental agency or court of competent jurisdiction to the extent such disclosure is required by a valid law, regulation or court order, and provided further, that, prompt notice thereof is given (unless such notice is prohibited by law) to the disclosing party of any such requirement or request.

8.7 Representations.

a. Use of Services.

(i) Customer represents that it is a telecommunications carrier under the Communications Act of 1934, as amended or under the laws of the jurisdiction where it operates. The parties do not contemplate, as of the Effective Date, the filing of any tariff as to the Services provided under this Agreement, however, in the event that due to a court or agency ruling, or change in applicable law or regulation, this Agreement becomes subject to a requirement of an FCC tariff, then MBO will file a contract tariff with the FCC incorporating all of the material terms and conditions of this Agreement, including pricing, and the parties agree to abide by that contract tariff. Service may also be subject to tariffs in jurisdictions outside of the United States, and MBO reserves the right to make its provision of Services subject to such tariff terms. Customer represents that it has taken all actions required by the FCC to operate as a telecommunications carrier under the Communications Act of 1934, as amended. Customer may engage in resale of international private lines for the provision of a switched, basic telecommunication service only upon authorization from the FCC under Section 214 of the Communications Act of 1934, as amended, and provided that the private line is used only (i) on a route where Customer exchanges switched traffic with a foreign carrier that the FCC has determined lacks market power; or (ii) on any route for with the FCC has authorized the provision of switched services over international private lines. Service shall not be used for any unlawful purpose.

(ii) Customer is responsible for ensuring that it and its customers comply with MBO' Acceptable Use Policy ("AUP") and Customer agrees to be bound by the AUP. The AUP, as it may be amended from time to time, is published at www.mbovideo.net, or such other address at MBO may specify by notice to Customer in accordance with Section 8 9 Notices Any violation of the AUP shall constitute a material breach of this Agreement.

b Customer Facilities Customer has sole responsibility for installation, testing and operation of facilities, services and equipment ("Customer Facilities") other than those specifically provided by MBO as part of the Services as described in a Client Service Purchase Order. In no event will the untimely installation or non-operation of Customer Facilities relieve Customer of its obligation to pay charges for the Services after Customer's acceptance or deemed acceptance.

c. Universal Service Exemption During the Term or Renewal Term of this Agreement, Customer shall provide MBO, on a semiannual basis, a universal service exemption certificate within thirty (30) days of the Customer's filing of the universal service filing made with the appropriate federal agency, evidencing that the Customer is required to contribute to the federal Universal Service Fund. Customer agrees that failure to provide such an exemption authorizes MBO to begin billing Customer prospectively for Universal Service Fund contributions pursuant to the applicable contribution factor (revised quarterly).

8 8 Title to Equipment. This Agreement shall not, and shall not be deemed to, convey to Customer title of any kind to any MBO owned or leased transmission facilities, digital encoder/decoders, telephone lines, microwave facilities or other facilities utilized in connection with the Services.

8 9 Notices All legal notices to be sent to a party pursuant to this Agreement shall be in writing and deemed to be effective upon (i) personal delivery, (ii) three (3) business days after mailing certified mail return receipt requested if mailed within the domestic U.S., or (iii) on the day when the notice has been sent by facsimile if sent during business hours and followed by private courier, or express mail priority, next-day delivery. The Full Business Address for purposes of notice under this Section as well as telephone voice and facsimile numbers shall be:

MBO Video, L.L.C.
One Main Street
Earlsboro, Oklahoma 74840
Telephone: (405) 997-5201
Fax: (405) 997-5500
Attention: Contract Administration

With a copy to:
Brad Heckenkemper
Barrow & Grimm, P.C.
110 W 7th Street, Suite 900
Tulsa, OK 74119-1044
Telephone: (918) 584-1600
Fax: (918) 585-2444

_____
_____
_____
Telephone:
Fax:
Attention:

For billing issues to:
_____
_____
_____

Telephone:
Fax:

8.10 Written Amendment. Any addition, deletion or modification to this Agreement shall not be binding on either party except by written amendment executed by authorized representatives of both parties.

8.11 No Venture. The provision of Services shall not create a partnership or joint venture between the parties. The parties hereto are independent contractors.

8.12 Assignment. Neither Party shall assign or otherwise transfer (including, without limitation, a transfer due to a "Change of Control") its rights or obligations under this Agreement without the prior written consent of the other Party, which shall not be unreasonably withheld. Customer must be current on all payments required by this Agreement before any assignment is approved by MBO Any such assignment or transfer of Customer's rights or obligations without such consent shall entitle MBO to disconnect the Services provided hereunder at its option upon ten (10) calendar days' prior written notice to Customer and shall constitute a default of a material obligation. A Change in Control shall be deemed to be an assignment, merger, sale of a controlling interest or other transfer of a controlling ownership interest. Any assignment by either Party of any right, obligation, or duty, in whole or in part, or of any interest, without the written consent of the other Party shall be void, except that either Party may assign all of its rights, and delegate its obligations, liabilities and duties under this Agreement, either in whole or in part, to any entity that is, or that was immediately preceding such assignment, a Subsidiary

or Affiliate of that Party without consent, but with prior written notification. The effectiveness of any assignment shall be conditioned upon the assignee's written assumption of the rights, obligations, and duties of the assigning Party

8.13 Choice of Law. This Agreement shall be governed by the laws of the State of Oklahoma, U.S. without regard to choice of law principles. Customer hereby consents to the jurisdiction and venue of the federal and state courts having a situs in Pottawatomie County, Oklahoma, U.S.

8.14 Interpretation No rule of construction requiring interpretation against the draftsman hereof shall apply in the interpretation of this Agreement.

8.15 Priority of Agreement and Schedules. In the event of any inconsistency between or among a Client Service Purchase Order, this Agreement and MBO's Acceptable Use Policy, the following order of precedence shall prevail (from highest priority to lowest): the Acceptable Use Policy, this Agreement, a Client Service Purchase Order.

8.16 No Third Party Beneficiary. The provisions of this Agreement are for the benefit only of the parties hereto, and no third party may seek to enforce or benefit from these provisions.

8.17 Costs and Attorneys' Fees. If a proceeding is brought for the enforcement of this Agreement or because of any alleged or actual dispute, breach, default or misrepresentation in connection with any of the provisions of this Agreement, the prevailing party shall be entitled to recover reasonable attorneys' fees and other reasonable costs and expenses incurred in such action or proceeding in addition to any other relief to which such party may be entitled.

8.18 Severability. If any term or provision of this Agreement shall, to any extent, be determined to be invalid or unenforceable by a court or body of competent jurisdiction, then (a) both parties shall be relieved of all obligations arising under such provision and this Agreement shall be deemed amended by modifying such provision to the extent necessary to make it valid and enforceable while preserving its intent, and (b) the remainder of this Agreement shall be valid and enforceable.

8.19 No Waiver. The failure of either party to enforce any provision hereof shall not constitute the permanent waiver of such provision.

8.20 Publicity and References. Subject to Section 8.6 Proprietary Information, the parties contemplate and agree that publication of information relating to this Agreement may occur through press releases, articles, interviews, marketing materials, online materials, and/or speeches ("Publicity"). Both parties must approve the content of any such Publicity prior to its publication, which approval shall not be unreasonably withheld. Routine references to the fact that Customer is a customer of MBO and the general nature of services that Customer purchases under this Agreement are not considered Publicity for purposes of this section, and Customer and MBO each authorize the other, during the term of this Agreement, to make such references.

8.21 Headings. Descriptive headings contained in this Agreement are for convenience and not intended as substantive portions of the Agreement. Such headings shall have no affect upon the construction of the Agreement.

8.22 Industry Terms. The parties intend that words having well-known technical or trade meanings shall be accorded such meaning, unless expressly defined otherwise.

8.23 Definitions. For purposes of this Agreement, capitalized words and phrases shall have the respective meanings assigned to them in this Agreement.

8.24 Counterparts This Agreement may be executed in one or more counterparts, each of which shall be deemed an original and all of which together shall constitute one and the same agreement. Facsimile signatures shall be deemed original signatures.

8.25 General Applicability of Provisions Unless expressly excluded, all terms of this Agreement are applicable to all sections of this Agreement, notwithstanding the specific reference to such a term in any other particular section.

8.26 Intellectual Property Rights. Unless otherwise specifically agreed in writing by the parties, each party shall retain all right, title and interest in and to any intellectual property associated with the provision of Services. If it should be necessary for a party to practice any patent, copyright, trade secret or other non-trademark intellectual property of the other party to avail itself of the Services, the parties shall negotiate in good faith a license with respect to such intellectual property. Each party acknowledges that the other party's name is proprietary to the other party. This Agreement does not transfer, and confers no right to use, the name, trademarks (including service marks), patents, copyrights, trade secrets, other intellectual property or

CIC of either party, except as expressly provided herein. Neither party shall take any action inconsistent with the intellectual property rights of the other party.

8.27 Survival of Terms. No termination of this Agreement shall affect the rights or obligations of either party: (a) with respect to any payment for services rendered before termination; or (b) pursuant to other provisions of this Agreement that, by their sense and context, are intended to survive termination of this Agreement, including without limitation, indemnification and limitation of liability.

8.28 Merger/Integration. This Agreement consists of all the terms and conditions contained herein and in documents incorporated herein specifically by reference. This Agreement constitutes the complete and exclusive statement of the understanding between the parties and supersedes all proposals and prior agreements (oral or written) between the parties relating to Services provided hereunder.

IN WITNESS WHEREOF, the parties hereto have executed this Master Services Agreement effective as of the day and year first above written. The offer expressed in this Agreement is extended to Customer for thirty (30) calendar days from date of MBO' signature, but such offer shall expire immediately following such thirty (30) calendar day period

MBO Video, L.L.C.:

Signature of Authorized Representative

Gene Baldwin

Printed Name

VP

Title

4-12-08

Date of Signature

Cross Telephone Company, L.L.C.:

Signature of Authorized Representative

V. David Miller II

Printed Name

President

Title

4/10/08

Date of Signature

CONFIDENTIAL AND PROPRIETARY
Confidential Treatment Requested Pursuant to 47 C.F.R. 54.711(b)

Cross Telephone Company, L.L.C.

ATTACHMENT G

Memorandum prepared by the Law Office of Bennet & Bennet, PLLC

Law Offices of Bennet & Bennet, PLLC

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Daryl A. Zakov⅄
Robert A. Silverman
Erin P. Fitzgerald
Frederick W. Giroux#

** Admitted in DC & PA Only*
⅄Admitted in DC & WA Only
#Admitted in DC & MA Only

M E M O R A N D U M

To: **Jake Baldwin, General Counsel**
Cross Telephone Company

From: **Carri Bennet**
Howard Shapiro

Date: **October 18, 2017**

Re: **USAC Audit No. HC2016BE031**

Pursuant to your request, we have reviewed the draft report ("Report) prepared Moss Adams, LLP ("Moss Adams" "Auditor") in response to the above-referenced audit requested by the Universal Service Administration Company ("USAC"). Specifically, we have reviewed the Auditor's Finding #1 related to the treatment of certain expenses incurred by Cross Telephone Company ("Cross") in connection with its purchase of DS1 services from an affiliated company, MBO Video, LLC ("MBO"). For the reasons set forth below, it is our view that the Auditor incorrectly treated the purchase of DS1 transport services as an asset lease arrangement, rather than as the purchase of services and, in doing so, ignored the contractual agreements and arrangements between the parties as well as the guiding principles established by the International Accounting Standards Board ("IASB") and embodied in the Internal Revenue Code ("IRC").

Section 7701(e) of the IRC sets forth specific criteria to determine whether a particular arrangement should be characterized as a service contract or as a lease. That section states:

§ 7701

* * *

(e) **Treatment of certain contracts for providing services, etc**. A contract which purports to be a service contract shall be treated as a lease of property if such contract is properly treated as a lease of property, taking into account all relevant factors including whether or not:
(A) the service recipient is in physical possession of the property,
(B) the service recipient controls the property,

(C) the service recipient has a significant economic or possessory interest in the property,
(D) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract,
(E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and
(F) the total contract price does not substantially exceed the rental value of the property for the contract period.

26 U.S.C. §7701(e).

Despite the clarity of these criteria, the Auditor's Report contains absolutely no analysis or even a discussion as to the propriety of ignoring the Master Services Agreement between the parties and treating the provision of DS1 services by MBO to Cross as the lease of an asset rather than as the purchase of services. To the contrary, the Auditor's Report simply assumes, erroneously, that the arrangement between Cross and MBO must be classified as a lease, regardless of how that transaction has been structured by the parties.

Even a cursory review of the Master Services Agreement between Cross and MBO reveals that the arrangement is properly characterized as a services agreement and not a lease. Under the terms of this arrangement, MBO retains total control of the facilities used to provide the DS1 circuits. Indeed the fact that the agreement allows MBO at its discretion to utilize the facilities of third party providers in addition to or in lieu of its own facilities for any part of the communications pathway clearly indicates that Cross has been given neither physical possession of the facilities used to provide the DS1 circuits nor the right to control those facilities. Similarly, Cross retains no economic or possessory interest in the facilities and MBO bears the risk of all losses or damages to the facilities upon the occurrence of any catastrophic incident as well as the risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract. Finally, the facilities utilized by MBO to provide the DS1 service to Cross are part of an integrated communications platform owned and operated by MBO. This platform supports network redundancy that allows MBO at its sole discretion to re-route traffic in the event of a network failure and thus maintain service level obligations and quality of service standards which MBO is obligated to provide under the Master Services Agreement and associated documents. In his regard it is also significant that MBO's service platform is used not only to provide DS1 services to Cross but also to provide telecommunications services to other unaffiliated carriers as well, further underscoring the arms length nature of the service contract between MBO and Cross in this particular instance.

In 2011, the IRS issued a revenue ruling that specifically applied the leasing criteria contained in Section 7701(e) to distinguish telecommunications service contracts from leases. In Rev. Rul. 2011-24, 2011-41 I.R.B. 485 (copy attached), the IRS considered three hypothetical situations: the first where a telecommunications carrier provided dedicated circuits to a business customer using its own SONET platform; a second where the carrier utilized a

combination of dedicated circuits and the public switched telephone network ("PSTN") to provide services to its business customer; and a third where the telecommunications carrier provided dedicated circuits to its business customer to provide the telecommunications service, but also leased customer premises equipment to the customer. The customer chose the locations to be interconnected under all three agreements while the carrier retained ownership and control of the facilities and the flexibility to determine just how calls would be routed. In the third scenario, the customer retained the authority to remove leased equipment from the premises and use that equipment on other networks or at different locations. In all three cases, the IRS ruled that the service contracts were not leases and that the presence of a separate equipment lease did not convert the service agreement into a lease.

The cases described in the Revenue Ruling are not significantly distinguishable from the service contract arrangement in place between MBO and Cross. The Auditor has provided no evidence or reasoning to support its decision to characterize the Master Services Agreement as a lease. Any such characterization is erroneous and unsupported by law or the facts.

It should be noted that the Auditor's re-characterization of the Master Services Agreement as a lease arrangement is inconsistent with both Generally Accepted Accounting Principles (GAAP) and international accounting standards. The auditor's finding relies on a separations procedure required by Part 36 of FCC rules. *See* 47 C.F.R. Part 36. Part 36 of the FCC's Rules requires classification of accounts for separations purposes to be consistent with the Uniform System of Accounts (USOA). *See* 47 CFR 36.1(f). The Part 32 USOA Rules incorporate GAAP. *See* 47 CFR 32.1 and 32.12. GAAP defines a lease as "an agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time." ASC 840-10-20.

Further, under international accounting standards, the same treatment applies. In January 2016, the International Accounting Standards Bureau (IASB) issued International Financial Reporting Standard 16 ("IFRS 16") dealing with the proper reporting of leases with a term of 12 months or more. While IFRS 16 takes effect for annual periods beginning on or after January 1, 2019, the standard represents nearly a decade of debate and discussion on, *inter alia*, how to properly distinguish leases from service contract.

Under IFRS 16, a contract is, or contains, a lease if it *conveys the right to control the use* of an *identified asset* for a period of time in exchange for consideration. IFRS 16 states that control is conveyed where the customer has both the right to direct the identified asset's use and to obtain substantially all the economic benefits from that use. Where, as in the case of the Master Services Agreement between MBO and Cross, a supplier has a substantive right of substitution throughout the period of use, a customer does not have a right to use an identified asset. As to the requirement that asset be identified, IFRS 16 states that a capacity portion of an asset may still be considered an identified asset if it is physically distinct (*e.g*., a floor of a building). However the capacity or other portion of an asset that is not physically distinct (*e.g*. a capacity portion of a fiber optic cable) is not an identified asset unless it represents substantially all the capacity of the asset and the customer obtains substantially all the economic benefits from using the asset. As indicated above, capacity provided by MBO to

Cross is provided as part of a larger system that is used by MBO to service customers other than Cross.

Based on the foregoing and consistent with Section 7.37 of the Government Accounting Office's Government Auditing Standards, Revision 2011, the Auditor must reconsider and amend its Finding #1 so that it is consistent with statutory and case law as well as the standards published by GAAP and the IASB. If the auditor continues to disagree with our legal analysis, the auditor is required to state its basis for its disagreement.

If you have any questions, would like additional information regarding this matter, please contact us.

Internal Revenue bulletin

Bulletin No. 2011-41
October 11, 2011

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2011–22, page 489.

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for October 2011.

Rev. Rul. 2011–24, page 485.

Telecommunications services under section 199. This ruling determines in certain situations whether a taxpayer providing telecommunications services is deriving gross receipts from services, leasing or renting property, or some combination thereof for purposes of the domestic production activities deduction under section 199 of the Code.

Notice 2011–74, page 496.

This notice provides for the suspension of certain requirements under section 42 of the Code for low-income housing credit projects in order to provide emergency housing relief needed as a result of the devastation caused by Tropical Storm Irene in Vermont beginning on August 27, 2011.

Notice 2011–79, page 498.

Extension of replacement period for livestock sold on account of drought. This notice explains the circumstances under which the 4-year replacement period under section 1033(e)(2) of the Code is extended for livestock sold on account of drought. The Appendix to this notice contains a list of the counties that experienced exceptional, extreme, or severe drought during the preceding 12-month period ending August 31, 2011. Taxpayers may use this list to determine if an extension is available.

EXEMPT ORGANIZATIONS

Announcement 2011–63, page 503.

The IRS has revoked its determination that Allied Veterans of the World, Inc., & Affiliates of Charlotte, NC; Metropolitan Financial Management Corporation of Roseville, MN; Saint Rest No. 2 Missionary Baptist Church of Chicago, IL; American Homebuyers Foundation, Inc., of Conyers, GA; Bundle of Joy Daycare, Inc., of Long Beach, CA; Columbia Basin Animal Rescue and Protection Agency of Kennewick, WA; Handicap Interests International and World Religions of Saranac Lake, NY; Holographic Ecology, Inc., of Santa Barbara, CA; Mattie's Maternity Homes of Palmdale, CA; Monytek Human Services, Inc., of Pendleton, OR; and Community Day Care Center of Abbeyville, LA, qualify as organizations described in sections 501(c)(3) and 170(c)(2) of the Code.

EMPLOYMENT TAX

Announcement 2011–64, page 503.

This announcement provides notice and details regarding the new Voluntary Classification Settlement Program (VCSP). The VCSP will allow eligible taxpayers to obtain similar relief to that obtained in the current Classification Settlement Program (CSP), which is only available to taxpayers under IRS examination. The VCSP is optional and provides taxpayers with an opportunity to voluntarily reclassify their workers as employees for future tax periods with limited federal employment tax liability for the past nonemployee treatment. To participate, taxpayers must meet certain eligibility requirements, apply to participate in VCSP, and enter into a closing agreement with the IRS.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

ADMINISTRATIVE

T.D. 9545, page 490.
Final regulations under section 6404 of the Code relate to the suspension of interest, penalties, additions to tax, or additional amounts under section 6404(g). Notice 2007–93 obsoleted.

Notice 2011–78, page 497.
This notice provides relief to insurance companies administering certain self-insurance arrangements on behalf of an employer or other entity from any information reporting obligations under section 6050W of the Code. Insurance companies may rely on this notice until the regulations under section 6050W are amended.

The IRS Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are compiled semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2011. See Rev. Rul. 2011-22, page 489.

Section 199.—Income Attributable to Domestic Production Activities

26 CFR 1.199–3: Domestic production gross receipts.
(Also: § 7701.)

Telecommunications services under section 199. This ruling determines in certain situations whether a taxpayer providing telecommunications services is deriving gross receipts from services, leasing or renting property, or some combination thereof for purposes of the domestic production activities deduction under section 199 of the Code.

Rev. Rul. 2011–24

ISSUE

In the situations described below, does a taxpayer that provides telecommunication services derive gross receipts from services to customers, leasing or renting property to customers, or some combination thereof for purposes of the domestic production activities deduction under § 199 of the Internal Revenue Code?

FACTS

Situation 1. *Z* corporation is in the business of providing telecommunication services, including the transmission of voice, data, and video communications. *Z* contracts with *A*, a corporation that is not in the telecommunications industry, to transmit *A*'s telecommunications. *A* has multiple business locations. The contract requires *Z* to transmit *A*'s telecommunications at *A*'s desired times, to *A*'s desired destinations, and at a certain speed. If *Z* cannot transmit *A*'s telecommunications according to the terms of the contract, then the contract requires *Z* to provide *A* with a service credit. The contract requires *A* to make payments to *Z* for transmitting *A*'s telecommunications.

Z's optical and digital transmission equipment, usually a Synchronous Optical Network (SONET) ring, and the associated Public Switched Telephone Network (PSTN) are used to transmit *A*'s telecommunications. *Z*'s SONET ring is deployed in a ring topology and interconnects multiple business locations designated by *A* so that telecommunications can be transmitted between *A*'s business locations without being transmitted to *Z*'s PSTN. The SONET ring also connects with *Z*'s central office, switching center, or remote terminal so that telecommunications can be transmitted to and from *Z*'s PSTN.

The PSTN is comprised primarily of fiber optic cable and copper cable that connects switching centers with each other and connects switching centers to remote terminals. The PSTN is owned by *Z* and is not dedicated to *A* or to any of *Z*'s other customers. *Z*'s PSTN provides a multitude of different pathways to transmit telecommunications to and from *A*'s business locations. The SONET ring and PSTN assets used to transmit *A*'s telecommunications include: (1) network electronics, such as multiplexers, switches, routers, digital cross connects, optical and digital transmission equipment; (2) fiber optic cable and/or copper cable; (3) network facilities such as a central office; and (4) software.

A owns some telecommunications equipment that connects with the SONET ring to allow transmission of *A*'s telecommunications between *A*'s business locations or to the PSTN, and transmission of others' telecommunications to *A* from the PSTN. *A*'s telecommunications equipment is located solely on *A*'s side of the demarcation point (point of interconnection) as that term is used in 47 C.F.R. Part 68. *A*'s telecommunications equipment typically includes a router, a channel service unit/data service unit, and diagnostics modem (collectively the "customer premises equipment"). The contract does not require *Z* to provide any services related to *A*'s customer premises equipment.

Z owns, installs, operates, and maintains the SONET ring and PSTN. *Z* will replace any SONET ring and PSTN assets when repairs or upgrades are required. The contract requires that *A* grant *Z* reasonable access to *A*'s premises for the purpose of installing, inspecting, testing, rearranging, maintaining, repairing, or removing any of the SONET ring assets located on *A*'s premises. *Z* maintains and repairs the SONET ring and PSTN at no additional charge to *A*. *A* is prohibited from installing, inspecting, testing, rearranging, maintaining, repairing, or removing any component of the SONET ring and/or PSTN.

Situation 2. The facts and circumstances are the same as in *Situation 1*, except *A* does not have multiple business locations and *Z*'s dedicated circuit, instead of a SONET ring, is used to transmit *A*'s telecommunications to the PSTN and others' telecommunications from the PSTN. All telecommunications transmitted to or from *A* must be transmitted using the PSTN. *Z*'s dedicated circuit, also referred to as the "local loop" or "last mile," is comprised of *Z*'s equipment (copper or fiber optic cable, point of presence equipment, and dedicated or shared equipment). *Z* generally does not notify *A* if *Z* repairs the dedicated circuit or PSTN. *Z* may notify *A* if *Z* upgrades the dedicated circuit or PSTN. *A* cannot stop *Z* from making any necessary repairs or upgrades to the dedicated circuit or PSTN.

Situation 3. The facts are the same as *Situation 2* except that *A* does not own the customer premises equipment required to connect with the dedicated circuit to allow transmission of *A*'s telecommunications. As part of the contract for *Z* to transmit *A*'s telecommunications, *Z* also provides the customer premises equipment, and provides support services to *A* in relation to managing the customer premises equipment. The contract provides that it is a lease of the customer premises equipment to *A*, but does not separately state the lease amount.

Z delivers and installs the customer premises equipment on *A*'s premises. *Z*, if necessary, helps maintain the customer premises equipment by providing telephone support services to *A*'s designated employees related to diagnosing problems and repairing and replacing the customer

premises equipment. *Z* can also remotely perform certain maintenance or diagnostic tasks. *A*'s designated employees complete any required repair or replacement. *A* is liable for any repair charges or the replacement cost of the customer premises equipment if it is damaged or lost. *A* can relocate or modify the customer premises equipment, and may attach it to non-*Z* equipment with *Z*'s written authorization, which may not be unreasonably withheld. When the contract terminates, if *A* does not return the customer premises equipment or make it available for removal by *Z*, then *A* is liable to *Z* for the customer premises equipment's then current market value. *A* is liable for costs of any restoration of the customer premises equipment beyond ordinary wear and tear.

LAW AND ANALYSIS

Section 199(a)(1) allows a deduction equal to 9 percent (3 percent in the case of taxable years beginning in 2005 or 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of (A) the qualified production activities income (QPAI) of the taxpayer for the taxable year, or (B) taxable income (determined without regard to § 199) for the taxable year (or, in the case of an individual, adjusted gross income).

Sections 199(b)(1) and (b)(2) limit the amount of the deduction allowable under § 199(a) to 50 percent of the W–2 wages of the taxpayer for the taxable year that are allocable to domestic production gross receipts (DPGR).

Section 199(c)(1) defines QPAI for any taxable year as an amount equal to the excess (if any) of (A) the taxpayer's DPGR for such taxable year, over (B) the sum of (i) the cost of goods sold that are allocable to such receipts; and (ii) other expenses, losses, or deductions (other than the deduction under § 199) that are properly allocable to such receipts.

Section 199(c)(4)(A)(i)(I) provides that the term DPGR means the taxpayer's gross receipts that are derived from any lease, rental, license, sale, exchange, or other disposition of qualifying production property that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States.

Section 1.199–3(i)(1) of the Income Tax Regulations provides that applicable Federal income tax principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange, or other disposition, whether it is a service, or whether it is some combination thereof. Section 1.199–3(i)(4)(i)(A) provides that gross receipts derived from the performance of services generally do not qualify as DPGR.

Section 1.199–3(i)(6)(ii) provides that gross receipts derived from customer and technical support, telephone and other telecommunication services, online services (such as Internet access services, online banking services, providing access to online electronic books, newspapers, and journals), and other similar services do not constitute gross receipts derived from a lease, rental, license, sale, exchange, or other disposition of computer software. *Example 3* of § 1.199–3(i)(6)(v) concludes that gross receipts derived from telephone and related telecommunication services run by computer software produced by the taxpayer are attributable to a service and do not constitute gross receipts derived from a lease, rental, license, sale, exchange, or other disposition of computer software.

Rev. Rul. 68–109, 1968–1 C.B. 10, holds that switchboards or dial switching apparatus installed by the taxpayer, a regulated communications utility, at a customer location and used to furnish communications services to tax-exempt organizations or governmental units were eligible for the investment tax credit because the equipment installed was not owned or leased by the tax-exempt organizations or governmental units. The taxpayer retained all ownership in, and possession and control over, the equipment. The agreement entered into between the taxpayer and the customer was not a sale or lease but a service contract. The services furnished by the taxpayer and the manner in which they must be furnished were described in tariffs (which did not include provisions that authorized the taxpayer to sell or lease any of the property in question) on file with the Federal Communications Commission, and with the pertinent state public utility regulatory agencies.

Rev. Rul. 72–407, 1972–2 C.B. 10, holds that fully serviced vehicles that were furnished on a daily basis to a department of the United States Government were ineligible property for purposes of the investment tax credit because the vehicles were provided under a lease arrangement rather than a service contract. The ruling reasons that the provision of vehicles was more analogous to the facts under Rev. Rul. 71–397, 1971–2 C.B. 63 (in which an owner-manufacturer's machines placed with and for the use of tax-exempt organizations and governmental units were not eligible for the investment tax credit because the manufacturer did not have possession and use of the machines), than to the facts under Rev. Rul. 68–109. The ruling reasons that, because the vehicles were not part of an integrated network and no government regulations prohibited a lease of the vehicles, provision of the vehicles was fundamentally different from the provision of communications services considered in Rev. Rul. 68–109. The vehicles were provided to the governmental unit by the taxpayer; however, the taxpayer did not use them to render services to the governmental unit. Instead, the placement of the vehicles with the governmental unit allowed the governmental unit to provide services to itself.

In addition, case law addresses whether a contract is a lease or a service contract. For example, in *Xerox Corporation v. United States*, 656 F.2d 659 (Ct. Cl. 1981), the court held that machines were eligible for the investment tax credit because the machines were not leased but supplied as an integral part of service. The court, after citing Rev. Rul. 68–109 and other rulings, focused the service-versus-lease analysis on the possessory interest a taxpayer retains in the property and whether the property is part of an integrated operation. The court described four factors to use when analyzing the possessory interest: (1) retention of property ownership by taxpayer (*see* Rev. Rul. 68–109); (2) retention of possession and control of the property by taxpayer (*see* Rev. Rul. 68–109 and Rev. Rul. 71–397); (3) retention of risk of loss by the taxpayer (*see* Rev. Rul. 68–109); and (4) reservation of the right to remove the property, and replace it with comparable property.

In *Smith v. Commissioner*, T.C. Memo. 1989–318, in determining whether the taxpayer was eligible for the investment tax credit, the court listed four factors for distinguishing leases from service contracts: (1) which party has the use and possession or control of the equipment; (2) which

party operates the machine; (3) whether the tax-exempt organization pays for the use of the machine for some duration, or, instead pays based upon the number of procedures executed; and (4) whether the equipment is part of a broader, integrated system of equipment and services.

Applicable Federal income tax principles relevant to determining whether a taxpayer's gross receipts are derived from providing telecommunication services or from a lease or rental of property include the factors described in § 7701(e)(1). Section 7701(e)(1) provides that for purposes of chapter 1, of which § 199 is a part, a contract that purports to be a service contract shall be treated as a lease of property if such contract is properly treated as a lease of property taking into account all relevant factors, including whether or not (A) the service recipient is in physical possession of the property, (B) the service recipient controls the property, (C) the service recipient has a significant economic or possessory interest in the property, (D) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract, (E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and (F) the total contract price does not substantially exceed the rental value of the property for the contract period.

Although authorities on Federal income tax principles such as those summarized above demonstrate that Federal income tax principles are generally used to determine a single character for a given transaction, § 1.199–3(i)(1) provides that, solely for purposes of § 199, a single transaction may, depending on applicable Federal income tax principles, have both a services element and a lease element. Accordingly, the application of Federal income tax principles described in § 1.199–3(i)(1) requires an analysis of relevant factors taken from Federal income tax principles, but does not require a determination of a single character. However, analysis of the relevant factors may lead to a determination that the transaction has only a single character element for purposes of § 199.

In *Situation 1*, under the applicable Federal income tax principles described above, *Z* is using its SONET ring and PSTN to provide telecommunication services to *A*, not providing a combination of telecommunication services with a lease or rental of *Z*'s SONET ring or PSTN to *A*. Although a determination for § 199 purposes that a transaction constitutes exclusively the provision of services requires thorough consideration of all relevant facts and circumstances, several significant factors in *Situation 1* support this conclusion.

For instance, *Z* maintains control of the SONET ring and PSTN that are necessary for *Z* to fulfill the conditions of its contract with *A*. To fulfill the contract terms, *Z* must transmit *A*'s telecommunications at *A*'s desired times, to *A*'s desired destinations, and at a certain speed. *A* contracts with *Z* for the quantity and quality of telecommunication services, but does not control how *Z* uses the SONET ring and PSTN to provide the services.

Further, *A* does not have a possessory interest in the SONET ring and PSTN that *Z* uses to complete the transmissions. *Z* must operate the SONET ring and PSTN because, if *A* makes the payments due under the contract to *Z*, *Z* is required to transmit *A*'s telecommunications. *A* does not operate, maintain, repair or upgrade the SONET ring and PSTN. *A* grants *Z* reasonable access to *A*'s premises for the purpose of installing, inspecting, testing, rearranging, maintaining, repairing, or removing any of the SONET ring assets located on *A*'s premises. *Z* operates, maintains, repairs, and upgrades the SONET ring and PSTN at no additional charge to *A*. *A* is prohibited from installing, inspecting, testing, rearranging, maintaining, repairing, or removing any component of the SONET ring or PSTN. *Z* is the party with a possessory interest in the SONET ring and PSTN. *Z* must be able to operate the SONET ring and PSTN because, if *Z* cannot transmit *A*'s telecommunications according to the terms of the contract (*i.e.*, *A*'s desired times, destinations, and speed), then *Z* is required to provide a service credit.

In addition, the SONET ring and PSTN are part of *Z*'s broader integrated operation of transmitting telecommunications. While the SONET ring allows *Z* to transmit *A*'s telecommunications between *A*'s designated business locations without accessing *Z*'s PSTN, the SONET ring also connects with *Z*'s central office, switching center, or remote terminal so that telecommunications can be transmitted to and from *Z*'s PSTN. The PSTN is owned by *Z* and is not dedicated to *A* or to any of *Z*'s other customers. The PSTN provides a multitude of different pathways to transmit telecommunications to and from *A*'s business locations.

In this situation, *A* contracts with *Z* for reliable telecommunication services and *Z* provides those services using its SONET ring and PSTN subject to the contract terms governing the quantity and quality of services that *Z* must provide. Accordingly, *Z*'s gross receipts derived from transmitting *A*'s telecommunications are derived from the performance of services without the lease or rental of *Z*'s SONET ring and PSTN to *A* for purposes of § 199.

In *Situation 2*, under the applicable Federal income tax principles described above, *Z* is using the dedicated circuit and PSTN to provide telecommunication services to *A*, not providing a combination of telecommunication services with a lease or rental of *Z*'s dedicated circuit or PSTN to *A*. Although a determination for § 199 purposes that a transaction constitutes exclusively the provision of services requires thorough consideration of all relevant facts and circumstances, several significant factors in *Situation 2* support this conclusion.

For instance, *A* does not control the dedicated circuit or PSTN as *Z* maintains the same control as *Z* has over the SONET ring and PSTN in *Situation 1*. Further, *A* does not have a possessory interest in the dedicated circuit and PSTN that *Z* uses to complete the transmissions. *Z*, in fact, has broader access to a dedicated circuit than a SONET ring. Also, the dedicated circuit is part of *Z*'s broader integrated operation. The dedicated circuit must connect with *Z*'s PSTN to transmit telecommunications to and from *A*'s business location.

In this situation *A* contracts with *Z* for reliable telecommunication services and *Z* provides those services using its dedicated circuit and PSTN subject to the contract terms governing the quantity and quality of services that *Z* must provide. Accordingly, *Z*'s gross receipts derived from transmitting *A*'s telecommunications are derived from the performance of services without the lease or rental of *Z*'s dedicated circuit or PSTN to *A* for purposes of § 199.

In *Situation 3*, under the applicable Federal income tax principles described above, *Z* is providing a combination of

telecommunication services using its dedicated circuit and PSTN and a lease or rental of *Z*'s customer premises equipment to *A*. Although a determination for § 199 purposes that a transaction constitutes a combination of services and a lease or rental requires thorough consideration of all relevant facts and circumstances, several significant factors in *Situation 3* support this conclusion.

With respect to the dedicated circuit and PSTN, the same analysis applies to *Situation 3* as applied in *Situation 2*. In this situation, *A*'s contract with *Z* also includes the provision of customer premises equipment. The customer premises equipment is necessary to allow *A* to connect with the dedicated circuit so that *Z* can transmit telecommunications to and from *A*'s business location.

A controls the customer premises equipment in generally the same manner as in *Situation 2* where *A* owns the customer premises equipment. However, in this case, *Z* owns, provides necessary telephone support services for, and can perform certain remote maintenance and diagnostic tasks on the customer premises equipment. Nevertheless, *A* has a possessory interest in the customer premises equipment. *Z* must operate the dedicated circuit and PSTN, but just as in *Situation 2*, *A* operates the customer premises equipment. *A* designates employees to perform equipment replacement and repair of the customer premises equipment. *Z* provides telephone assistance, but only if necessary. *A* can relocate or modify the customer premises equipment, and may attach it to non-*Z* equipment with *Z*'s written authorization, which may not be unreasonably withheld. *A* is liable for any repair charges or the replacement cost of the equipment if it is damaged or lost. When the contract terminates, if *A* does not return the customer premises equipment or make it available for removal by *Z*, then *A* is liable to *Z* for the customer premises equipment's then current market value. If *A* does return it and the customer premises equipment has more than ordinary wear and tear, then *A* is liable for those restoration costs. The facts demonstrate in this situation that *A* has a possessory interest in the customer premises equipment.

Because *A* is ultimately the party responsible for ensuring that the customer premises equipment is available to connect with the dedicated circuit to allow *Z* to transmit telecommunications to and from *A*'s business location using *Z*'s dedicated circuit and PSTN, the customer premises equipment should not be considered part of *Z*'s broader integrated network.

In this situation *A* contracts with *Z* for reliable telecommunication services and *Z* provides those services using its dedicated circuit and PSTN subject to the contract terms governing the quantity and quality of services that *Z* must provide, but *A* also contracts for the lease or rental of customer premises equipment. Accordingly, *Z*'s gross receipts derived from transmitting *A*'s telecommunications are derived from a combination of services using its dedicated circuit and PSTN and a lease or rental of the customer premises equipment to *A*.

The terms "lease" and "rent" are used interchangeably throughout the Code, and for purposes of this analysis a distinction is unnecessary. The characterization of a transaction as a combination of services and a lease as opposed to a combination of services and a rental has no effect under § 199.

HOLDINGS

In *Situation 1*, *Z*'s gross receipts are derived from the performance of telecommunication services without the lease or rental of *Z*'s SONET ring and PSTN to *A* for purposes of § 199 and do not constitute DPGR.

In *Situation 2*, *Z*'s gross receipts are derived from the performance of telecommunication services without the lease or rental of *Z*'s dedicated circuit and PSTN to *A* for purposes of § 199 and do not constitute DPGR.

In *Situation 3*, *Z*'s gross receipts are derived from a combination of the performance of telecommunication services using its dedicated circuit and PSTN and a lease or rental of the customer premises equipment described above to *A* for purposes of § 199. *Z*'s gross receipts derived from the performance of services do not constitute DPGR and *Z*'s gross receipts derived from the lease or rental of the customer premises equipment only qualify as DPGR if *Z* meets the other requirements of § 199 with respect to the customer premises equipment.

DRAFTING INFORMATION

The principal author of this revenue ruling is James A. Holmes of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this revenue ruling, contact Mr. Holmes at (202) 622–3040 (not a toll-free call).

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of October 2011. See Rev. Rul. 2011-22, page 489.

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of October 2011. See Rev. Rul. 2011-22, page 489.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2011. See Rev. Rul. 2011-22, page 489.

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2011. See Rev. Rul. 2011-22, page 489.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2011. See Rev. Rul. 2011-22, page 489.
